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S. HRG. 102-365

HE MONETARY POLICY REFORM ACT OF 1991

P15 63

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

OF THE

COMMITTEE ON NKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

S. 1611

STABLISHED A FEDERAL OPEN MARKET ADVISORY COMMITTEE ICH SHALL CONSIST OF THE PRESIDENTS OF THE FEDERAL RE-VE BANKS. THE PRESIDENT OF THE FEDERAL RESERVE BANK OF V YORK SHALL BE THE CHAIRPERSON OF THE ADVISORY COM-TEE. THE MEETINGS OF THE ADVISORY COMMITTEE SHALL BE D IN WASHINGTON, DISTRICT OF COLUMBIA, NOT LESS THAN 4 ES A YEAR UPON THE CALL OF THE BOARD OF GOVERNORS OF FEDERAL RESERVE SYSTEM.

NOVEMBER 13, 1991

ed for the use of the Committee on Banking, Housing, and Urban Affairs

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The Monetary Policy Reform Act of 1991

Wednesday, November 13, 1991

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met, pursuant to notice, at 10:03 a.m., in room SD-538 of the Senate Dirksen Office Building, Senator Paul Sarbanes (chairman of the subcommittee) presiding.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The committee will come to order.

Chairman Riegle is on the floor. We're dealing with a motion to proceed to the banking bill. He had very much wanted to be here to open this hearing, but hopefully, he'll be able to join us later in the morning.

The Senate Banking Committee meets today to discuss S. 1611, the Monetary Policy Reform Act of 1991, which would vest full responsibility for the conduct of monetary policy with the Federal Reserve's Board of Governors. The bill is based on a fundamental tenet of democracy—those who make public policy must be accountable to the people.

The Federal Reserve is both the most important actor in the Nation's banking system and the Government agency in charge of monetary policy. It consists of a seven member Board of Governors in Washington and 12 regional Federal Reserve banks.

Within that system, the Federal Open Market Committee is the most important policy making group. It sets the targets for money supply growth and interest rates, decisions which affect the economic well-being of all Americans and decisions which should promote the Nation's broad economic goals.

The Federal Open Market Committee consists of the seven members of the Federal Reserve Board of Governors and five of the 12 regional bank presidents. The president of the New York Fed always has a vote; the other four have votes on a rotating basis. All of the bank presidents may attend and, as I understand, they usually do attend the FOMC meetings and participate in the discussions.

The seven Governors of the Federal Reserve are appointed by the President and confirmed by the Senate. They are publicly accountable for their conduct in office.

The bank presidents, on the other hand, are selected by the board of directors of the regional banks. Two-thirds of the directors of the regional banks are selected by member commercial banks.

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The other third, the so-called public representatives, are appointed by the Federal Reserve Board of Governors.

Thus, the bank presidents, while not public officials, share power with the Board of Governors in making very significant monetary policy decisions through their membership on the Federal Open Market Committee.

A recent article in the Wall Street Journal entitled, "Fed Banks' Presidents Hold Private Positions but Major Public Role," said of the current make-up of the FOMC, "It hands enormous power to people who need not answer to the public or the Government."

And it went on to note that the bank presidents, who are the voting members, straddle an odd but awesome combination of public and private power.

This hybrid arrangement is unique within our Government. It has no parallel among central banking systems in other major industrialized countries.

Many of our Government agencies use private citizens as advisors. But in no other agency are major policy decisions made directly by individuals who are not publicly accountable.

A recent study by the Joint Economic Committee on central bank/Government relations in other major industrialized countries found that those who governed the central bank and set monetary policy are nominated or appointed by public officials.

In Germany, for example, the president appoints the members of the Bundesbank Directorate, while the upper house of Parliament appoints the eleven central bank presidents. And so on, with Canada, Japan. All do it somewhat differently, but in every instance, there is a public selection of the people, in one way or another, the people who serve on the central bank.

This was a consequence of a study prepared for the Joint Economic Committee by Professor John Goodman of Harvard Business School.

A little history may be helpful.

The bank presidents have voting rights on the Federal Open Market Committee as a result of a political compromise made in the 1930's. Marriner Eccles, who was President Roosevelt's choice to be Chairman of the Federal Reserve, sought some fundamental changes in the conduct of monetary policy, among them that the Federal Reserve Board should have complete control of all open market operations.

At that time, the district banks had that power and Eccles suggested that their "narrow banking rather than broad social point of view" contributed to the Great Depression.

Eccles prevailed on some of the changes, but not all. And it was decided that open market operations were to be decided by an open market committee, on which the Board of Governors would share power with the regional bank presidents.

[The complete prepared statement of Senator Sarbanes follows:]

COMPLETE PREPARED STATEMENT OF SENATOR PAUL SARBANES

The Senate Banking Committee meets today to discuss S. 1611, the Monetary Policy Reform Act of 1991, which would vest full re-

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sponsibility for the conduct of monetary policy with the Federal Reserve's Board of Governors. The bill is based on a fundamental tenet of democracy: those who make public policy must be accountable to the American people.

The Federal Reserve is both the most important actor in the Nation's banking system and the Government agency in charge of monetary policy. The Federal Reserve System consists of seven-member Board of Governors in Washington and the 12 regional Federal Reserve Banks. Within the system, the Federal Open Market Committee (FOMC) is the most important policymaking group. The FOMC sets the targets for money supply growth and interest rates. These decisions affect the economic well-being of all Americans and should promote the Nation's broad economic goals.

The FOMC consists of the seven members of the Federal Reserve Board of Governors and 5 of regional bank presidents. The president of the New York Fed always has a vote; 4 others serve on the FOMC on a rotating basis. The other bank presidents may attend the FOMC meetings and participate in the discussions.

The Governors of the Federal Reserve are appointed by the President and confirmed by the Senate. They are publicly accountable for their conduct in office.

The bank presidents are selected by the Boards of Directors of the regional Banks. Two-thirds of the directors are selected by commercial banks. The other third—the so-called public representatives—are appointed by the Board of Governors.

The bank presidents are not public officials, yet they share power with the Board of Governors in making the most significant monetary policy decisions of the Federal Reserve system, through their membership on the FOMC.

A Wall Street Journal article, Fed Banks' Presidents Hold Private Positions but Major Public Role (8/1/91), says of the current make-up of the FOMC: "it hands enormous power to people who need not answer to the public or the Government." The article describes the situation of a regional bank president:

> He is paid like a private banker—$175,600 a year. His shareholders are private banks. His Board members are private citizens. His budget is free of congressional scrutiny—and it goes on to say that, by virtue of his position on the FOMC, he straddles an odd but awesome combination of public and private power.

The FOMC is a hybrid arrangement for public policy making that is unique within the U.S. Government and has no parallel among central banking systems in other major industrialized nations.

Many Governments agencies use private citizens as advisers, but in no other agency are major policy decisions made directly by individuals who are not publicly accountable.

A recent study for the Joint Economic Committee on central bank-government relations in other major industrialized countries found that in every major OECD country, those who govern the central bank and set monetary policy are nominated or appointed by public officials.

In Germany, for example, the President appoints the members of the Bundesbank Directorate, while the upper house of Parliament appoints the 11 Central bank presidents. The directors of the Bank of Canada are appointed by the Finance Minister. The voting mem-

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bers of the Policy Board of the Bank of Japan are appointed by the Cabinet with the consent of the Diet. In Switzerland, members of the governing board are appointed by the Federal Council. The study, Central Bank-Government Relations in Major OECD Countries, was prepared for the Joint Economic Committee by Professor John B. Goodman of Harvard Business School.

The bank presidents have voting rights on the FOMC as the result of a political compromise made in the 1930's. Marriner Eccles, President Roosevelt's choice as Federal Reserve Chairman, sought some fundamental changes in the conduct of monetary policy, among them that the Federal Reserve Board should have complete control of all open-market operations. At the time, the district banks had that power, and Eccles suggested that their "narrow banking rather than broad social point of view" contributed to the Great Depression.

Eccles prevailed on some of the changes, but not all. Open market operations were to be decided by Open Market Committee, on which the Board of Governors would share power with the regional bank presidents.

In this recession, with fiscal policy all but immobilized by the budget agreement, much of the responsibility for economic policy lies with the Federal Reserve and the FOMC. Yet, despite this enormous power, the FOMC does not conform to normal standards of Government accountability. It may not even fully conform to the requirements of our Constitution regarding the delegation of power.

These issues are addressed by the Monetary Policy Reform Act, which would make the Federal Reserve's Board of Governors fully responsible for the conduct of monetary policy and open market operations. The current FOMC would be dissolved, and a new Federal Open Market Advisory Committee (FOMAC) would be created. Through the FOMAC, the bank presidents could still participate in policy meetings and play an important consultative role. The Federal Reserve Board would still have the benefit of the bank presidents' advice, but significant monetary policy decisions would be the responsibility of public officials, nominated by the President and confirmed by the Senate.

In this recession, the one we're experiencing right now, with fiscal policy effectively immobilized by the budget agreement, much of the responsibility for economic policy lies with the Federal Reserve and the Federal Open Market Committee.

Yet, that committee doesn't conform to normal standards of Government accountability, and some have even questioned whether it meets the constitutional requirements regarding the delegation of power.

The legislation before us, which Chairman Riegle, Chairman Sasser, and I have introduced in the Senate, and which our first two witnesses this morning have introduced a comparable piece of legislation on the House side, seeks to address this issue by making the Board of Governors of the Federal Reserve the responsible parties for the conduct of monetary policy and open market operations.

The current open market committee would be dissolved, and a new Federal Open Market Advisory Committee would be created.

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Through this advisory committee, the bank presidents could still participate in meetings about policy and play an important consultative role.

The Federal Reserve Board would have the benefit of the bank presidents' advice, but significant monetary policy decisions would be the responsibility of the members of the Board of Governors, who are public officials nominated by the President and confirmed by the Senate.

[Copy of proposed bill follows:]

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102D CONGRESS
1ST SESSION

S. 1611

To provide for a Federal Open Market Advisory Committee, and for other purposes.

IN THE SENATE OF THE UNITED STATES

AUGUST 1 (legislative day, JULY 8), 1991

Mr. SARBANES (for himself and Mr. SASSER) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing and Urban Affairs

---

A BILL

To provide for a Federal Open Market Advisory Committee, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Monetary Policy Reform Act of 1991".

SEC. 2. MEMBERSHIP OF THE FEDERAL OPEN MARKET ADVISORY COMMITTEE.

Section 12A(a) of the Federal Reserve Act (12 U.S.C. 263(a)) is amended to read as follows:

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"(a)(1) There is established a Federal Open Market Advisory Committee (hereinafter referred to as the 'Advisory Committee'), which shall consist of the presidents of the Federal Reserve banks. The president of the Federal Reserve Bank of New York shall be the chairperson of the Advisory Committee. The meetings of the Advisory Committee shall be held in Washington, District of Columbia, not less than 4 times a year upon the call of the Board of Governors of the Federal Reserve System.

"(2) The Advisory Committee shall advise the Board on the conduct of open-market operations.".

SEC. 3. CONFORMING AMENDMENTS

(a) IN GENERAL.—Section 12A(b) of the Federal Reserve Act (12 U.S.C. 263(b)) is amended by striking "Committee" each place it appears and inserting "Board".

(b) UNITED STATES OBLIGATIONS.—Section 14(b)(2) of the Federal Reserve Act (12 U.S.C. 355(2)) is amended by striking "Federal Open Market Committee" and inserting "Board".

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Senator SARBANES. Now we have three very distinguished panels this morning. We're pleased first to start with Congressman Hamilton and Congressman Dorgan.

Congressman Hamilton is the Vice Chairman of the Joint Economic Committee. Congressman Dorgan is a member of the House Ways and Means Committee, and they have joined in introducing the Monetary Policy Reform Act, H.R. 3176, in the House.

They'll be followed by a panel which will consist of: James Tobin, the very distinguished economist, Nobel Prize winner, former member of the Council of Economic Advisers, and Preston Martin, former vice chairman of the Federal Reserve Board of Governors, and currently chairman of the board of WestFed Holdings.

And then finally, we'll have a panel consisting of: Don Hilty, the chief economist of the Chrysler Corporation; David Seiders, chief economist of the National Association of Homebuilders; and Mark Bernstein, an attorney with the firm of Morgan, Lewis & Bockius, who's written on the constitutional questions involved in perhaps an excessive delegation of authority.

Before we begin, I have statements from Senators Dixon and D'Amato to be inserted in the record.

STATEMENT OF SENATOR ALAN J. DIXON

Senator DIXON. Mr. Chairman, I would first like to thank you for calling today's hearing. I commend your continuing efforts to direct the committee's attention towards the important economic issues that affect our country. This guidance is extremely important as we are continuing to experience a State of economic decline.

In my State, and throughout the Nation, Americans are anxious about the economy. Most are unsure about the security of their jobs, while many have no jobs at all. There is a growing despair as millions of American families worry about making ends meet. These are difficult times for much of America, and these difficult times demand immediate, yet prudent responses.

The country is overburdened with debt, and the overwhelming dimensions of the deficit make an economic recovery increasingly more difficult. Clearly we are experiencing economically critical times. We must use every tool at our Government's disposal to dig ourselves out of this hole.

One such Governmental tool, used to affect our economy, is the regulation of the money supply by the Federal Reserve. Through their actions, important changes and modifications can help stabilize the economy and steer it in the right direction. It is exceedingly important, therefore, to see that this system functions appropriately.

The hearing today examines S. 1611, which would alter the role of the presidents of the individual Federal Reserve banks. These 12 presidents participate in monetary policy decisions VIA membership in the Federal Open Market Committee, where they cast 5 of the 12 votes that determine monetary policy and interest rates. Consequently these individuals, who are not appointed by the President, nor confirmed by the Senate, hold critical responsibility for our economic well being. I look forward to hearing from the

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witnesses assembled here today regarding the role of these 12 bank presidents and their influence on monetary policy.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, I would like to commend you for calling today's hearing to examine S. 1611, the "Monetary Policy Reform Act of 1991."

My distinguished colleagues who introduced S. 1611 raise the interesting point of putting monetary policy exclusively in the hands of the Federal Reserve Board of Governors.

I would be very interested in knowing how much a split in philosophy between the Federal Reserve Board of Governors and presidents of regional Federal Reserve Banks actually caused or contributed to the Federal Reserve's reluctant reduction in the discount and Federal funds rates of interest.

If there are competing interests among the members of the Federal Open Market Advisory Committee (FOMC), the structure of the membership may actually be counterproductive.

Given the obvious impact of effective monetary policy on our economy, particularly in establishing interest rates, it is important that Congress re-evaluate whether the Federal Reserve Board of Governors should share this role with the Federal Reserve bank presidents.

In making this evaluation, Congress should consider that the Federal Reserve bank president most likely offers a more hands-on perspective of the economy that could provide an important balance to the more scholarly perspective of the Federal Reserve Board of Governors.

Thank you, Mr. Chairman.

Senator SARBANES. With that by way of opening, I'm happy to turn to our two congressional witnesses. We're very pleased to have you here.

Chairman Hamilton, why don't you start off, and then we'll go to Congressman Dergan.

STATEMENT OF LEE HAMILTON, MEMBER, U.S. HOUSE OF REPRESENTATIVES, INDIANA, NINTH DISTRICT

Mr. HAMILTON. Thank you very much, Senator Sarbanes.

I certainly endorse your statement in full as you have made it and it will make my task a little easier because I can skip over large parts of my testimony.

I'm very pleased to join with my distinguished colleague, Representative Dorgan from the House Ways and Means Committee and North Dakota, and with you and Senator Sasser and Senator Riegle in sponsoring this legislation.

It's very, very simple legislation. It only makes two changes in present law. It dissolves the Federal Open Market Committee, assigns sole responsibility for open market operations to the Board of Governors of the Federal Reserve System. That's the first change.

The second change is that it establishes a new Federal Open Market Advisory Committee through which the presidents of the 12 regional Federal Reserve banks can advise the Board of Governors on open market operations and monetary policy.

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The whole point of this is simply to make the Federal Reserve properly accountable to the American people. The impetus for it comes from the history that you have mentioned a moment ago. It grew out of reports earlier this year that proposals by the Federal Reserve Beard Chairman, Alan Greenspan, to lower interest rates were being resisted by some of the regional Federal Reserve bank presidents who serve on the Federal Open Market Committee.

Those reports were for many of us disturbing reports. It indicated the Fed was moving too slowly at a time when the economy was in some difficulty, in recession, moving too slowly to take the necessary steps to lower interest rates.

But what strikes me most of all is that in a democratic Government, it really is not unusual for policy makers to disagree. But this was not in this instance a split among public officials.

Instead, it was a split between, on the one hand, a small handful of individuals, presidents of Federal Reserve banks, who essentially represent private interests. They were impeding the efforts by public officials to conduct monetary policy in the way that they thought was best for the Nation's economy.

As you've said, the status of the Federal Reserve Bank presidents and the Federal Reserve system is an anomaly in our Government. I need not repeat that. But it is striking that these bank presidents who owe their jobs to the boards of directors of the regional banks subject to the approval of the Board of Governors have such enormous economic power.

These regional boards of directors are dominated, as they should be, I suppose, by local commercial banks who appoint six of the nine directors. But neither the President of the United States, nor the Congress, has any role in selecting either the directors or the presidents of the Federal Reserve banks.

Now, these bank presidents are highly respected individuals. They're talented individuals. But none of them are properly appointed Government officials and they are not accountable to the American people for their performance in office.

Nonetheless, they participate in monetary policy decisions through their membership on the Federal Open Market Committee, where they cast five of twelve votes that determine monetary policy and interest rates in this country.

That situation, in which private individuals participate in monetary policy decisions, is an anomaly in our system of Government. Nowhere else, so far as I've been able to determine in the Government, are private individuals similarly permitted to participate in decisions which have such an enormous influences over the prosperity and well-being of the American people.

Almost all Government agencies, of course, call upon and use extensively private citizens for advice. The Federal Reserve does that. They have three panels today, advisory panels. I identify them in the statement. It's not necessary to go into them. But nowhere other than the Federal Reserve, so far as I've been able to determine, are private interests permitted to have a vote on Government policy.

So that's the concern that we have in bringing this bill forward.

Now there was a day when perhaps it didn't make all that much difference. Bank presidents on the FOMC did not cause the kind of

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concern that they're generating today because the Federal Reserve did not exercise all that much influence over our economy, or at least not as much influence as it does today.

I think all of the economists that are testifying now before the Joint Economic Committee, and I'm sure other committees of Congress, are saying that the economic action in this town today is at the Fed, not in the Congress and not with the President.

So today, then, it is very well known that the Fed is the chief way in which the Government influences the economy.

I'm impressed in my own constituency that people are now asking a lot of questions about the Federal Reserve and Federal Reserve policies. It makes a lot of difference today how the Fed is structured. Perhaps it didn't make all that much difference some years ago.

Policy making is the function of public officials, who have either been elected by the people or appointed in the appropriate manner.

That's the way it is everywhere else in Government. That's the way it ought to be in the Federal Reserve System at all.

The Monetary Policy Reform Act addresses this concern by assigning the conduct of monetary policy and the open market operations to the seven member Board of Governors of the Federal Reserve System, and that lodges responsibility among appointed public officials.

It also creates the advisory council as well.

Mr. Chairman, I just want to mention very quickly in passing that, so far as Mr. Dorgan and I are concerned, this is a companion measure to a broader bill, the Federal Reserve Reform Act of 1991, which he and I introduced last year and which we call your attention to for further study.

In summary, then, the Federal Reserve bank presidents, the status of those bank presidents, is an anomaly in our system of Government. They do not go through the normal appointment process.

Nonetheless, they participate in these monetary policy decisions through their membership and they have an important five votes to cast.

Power without accountability does not fit in the American system of Government. We've changed the Federal Reserve system in the past. It's now time, it seems to me, to take an additional step and a very, very modest step, indeed, to move further and take the next step to make the Federal Reserve more accountable.

I thank the Sonator for his attention and for his interest in this particular piece of legislation. Both Mr. Dorgan and I welcome his cosponsorship of it.

I ask, of course, that my statement be submitted to the record in full.

Senator SARBANES. The full statement will be included in the record and we very much appreciate the very powerful opening statement here.

Congressman Dorgan?

[The complete prepared statement of Representative Lee H. Hamilton follows:]

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MONETARY POLICY REFORM ACT OF 1991
TESTIMONY OF REP. LEE H. HAMILTON
Before the
SENATE COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS
on
Wednesday, November 13, 1991

Mr. Chairman, I am very pleased to be here this morning to testify on the Monetary Policy Reform Act of 1991. Rep. Dorgan and I introduced this measure in the House of Representatives on August 1, 1991, where it has been assigned the bill number H.R. 3176. Simultaneously, Senator Sarbanes and Senator Sasser -- both Members of this Committee -- introduced it in the Senate, where it has been assigned the number S. 1611.

The Monetary Policy Reform Act would make two changes in the structure of the Federal Reserve. First, it would dissolve the Federal Open Market Committee and assign sole responsibility for open market operations to the Board of Governors of the Federal Reserve System. Second, it would establish a new Federal Open Market Advisory Committee through which the presidents of the 12 regional Federal Reserve Banks could advise the Board of Governors on open market operations and monetary policy. Together, these changes would make the Federal Reserve properly accountable to the American people.

While the need for change has long been recognized, the impetus for this legislation grew out of reports earlier this year that proposals by Federal Reserve Board Chairman Alan Greenspan to lower interest rates were being resisted by some of the regional Federal Reserve Bank presidents serving on the Federal Open Market Committee.

These were disturbing reports. The nation's economy was in a recession. Output was falling and unemployment was rising. There was widespread agreement that the economy could be helped by lower interest rates and that the Fed should reduce interest rates. Yet, as a consequence of this split among the policy-makers on the Federal Open Market Committee, the Fed moved slowly -- some think too slowly -- to take the necessary steps to lower interest rates and stimulate the economy.

In a democratic government, it is not unusual for policy-makers to disagree. But this was not simply a split among public officials. Instead, a small handful of individuals -- presidents of the Federal Reserve Banks -- who essentially represent private interests was impeding efforts by public officials to conduct monetary policy in the way they thought was best for the nation's economy.

The status of the Federal Reserve Bank presidents in the Federal Reserve System is an anomaly in our system of government. It requires some explanation. The Federal Reserve System was created by Congress in 1913 to manage the nation's financial

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affairs. It consists of the Board of Governors in Washington, which oversees the system and sets most of the policies, and the twelve regional Federal Reserve Banks, which carry out the day-by-day functions of the system. The Board of Governors has seven members, who are appointed by the President and confirmed by the Senate to 14-year terms. The Governors of the Federal Reserve are thus duly-appointed government officials who are accountable to the President and Congress, and through them to the American people, for their conduct in office.

At the Federal Reserve Banks, the top officials, in contrast, do not go through the normal appointment process. The Federal Reserve Bank presidents owe their jobs to the Boards of Directors of the regional Banks, subject to the approval of the Board of Governors. These regional Boards of Directors are dominated by local commercial banks, who appoint six of the nine directors. Neither the President nor Congress has any role in selecting either the directors or the presidents of the Federal Reserve Banks. Some of the Bank presidents are career employees, others have backgrounds in banking, business and academics; they are talented and respected individuals. But none are properly-appointed government officials, and they are not accountable to the American people for their performance in office. Nonetheless, they participate in monetary policy decisions through their membership on the FOMC, where they cast five of the twelve votes that determine monetary policy and interest rates.

This situation, in which private individuals participate in monetary policy decisions, is an anomaly in our system of democratic government. Nowhere else in the government are private individuals similarly permitted to participate in decisions which have such an enormous influence over the prosperity and well-being of millions of Americans.

Almost all government agencies make extensive use of private citizens in an advisory status. The Federal Reserve, itself, has three major advisory panels which meet with the Board of Governors three to four times a year -- the Federal Advisory Council, a panel of 12 bankers which advises the Board of Governors "on all matters within the jurisdiction of the Board;" the Consumer Advisory Council, which advises the Board on consumer financial services; and the Thrift Institutions Advisory Council, which advises the Board on issues pertaining to the thrift industry. Other government agencies have similar advisory panels. Private citizens serve on all these panels, but all they do is advise. Nowhere other than the Federal Reserve are representatives of private interests permitted to have a vote on government policy.

Among legal scholars, the present composition of the FOMC raises grave constitutional concerns. Those who have examined the conditions under which Congress has delegated powers to other branches and agencies of government and to independent commissions suggest that giving private individuals on the FOMC the right to vote on monetary policy is constitutionally flawed, if not unconstitutional. I would like to quote from a letter from Professor Harold Krent of Case Western Reserve's Law

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School:

> As currently constituted, the participation of private members on the FOMC raises fundamental constitutional concerns because the private individuals are not accountable to the public for their exercise of governmental authority.... The participation of private members on the FOMC cannot be easily reconciled with the focus on accountability underlying our system of separated powers.... The proposed bills would rectify that constitutional flaw by limiting the role of the private bank presidents to advice, a function fully compatible with the private status of the bank presidents.

The current structure of the Federal Reserve, and the Federal Open Market Committee in particular, is not locked in stone. Over the years, there have been many changes. In fact, between the founding of the Federal Reserve System in 1913 and the enactment of the major banking laws in 1935 and 1936, there was no Federal Open Market Committee to guide open market operations. The regional Federal Reserve Banks bought and sold Treasury securities on their own initiative, and the process frequently proved disruptive to Treasury financing plans and to the economy. When Marriner Eccles became Chairman of the Federal Reserve Board under President Roosevelt, his list of proposals to make the Federal Reserve more accountable included giving the Board of Governors full authority over open market operations. The current structure is the result of a compromise. In order to consolidate open market operations under the newly-created Federal Open Market Committee, Eccles and Roosevelt had to compromise with supporters of the Banks by giving the regional Federal Reserve Banks five of the 12 votes on the FOMC. It is now time to move further and take the next step to make the Federal Reserve more accountable.

During the early decades of the Federal Reserve, anomalies such as the role of the Bank presidents on the FOMC did not cause the concern they do today because the Federal Reserve did not exercise the influence over our economy that it does today. Not much was known about the Fed years ago and people didn't feel it had much impact on their lives.

But times have changed. Today, it is well known that the Federal Reserve is the chief way the government influences the economy. When I am in Indiana, people spontaneously ask me about the Federal Reserve and Federal Reserve policies. They recognize the power of the Fed and the way it affects their own personal well-being. It makes a lot of difference today how the Federal Reserve is structured. Policy-making is the proper function of public officials who have either been elected by the people or appointed in the appropriate manner, and that is the way it should be at the Federal Reserve.

The Monetary Policy Reform Act would address this concern by assigning the conduct of monetary policy and open market operations to the seven-member Board of

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Governors of the Federal Reserve System, thus lodging this responsibility with properly-appointed public officials. It would also create a special new Federal Open Market Advisory Council through which the presidents of the regional Federal Reserve Banks could advise the Board on monetary policy. The Bank presidents would no longer have a vote on monetary policy, but the Board of Governors would still have the benefit of their advice.

Before closing, I would like to point out, Mr. Chairman, that the Monetary Policy Reform Act is a companion measure to H.R. 1130, the Federal Reserve Reform Act of 1991, which Rep. Dorgan and I introduced earlier this year.

The Federal Reserve Reform Act would address other anomalies by which the Federal Reserve fails to conform to the normal standards of accountability in a democracy:

- Monetary policy is decided in secret, behind closed doors.
- The Federal Reserve is not required to consult with Congress or the Administration before setting money or interest rate targets, even though its power affects the financial well-being of every American.
- It waits six weeks before releasing policy decisions.
- The President, who is responsible for the performance of the economy and is blamed if things go wrong, often must wait until late in his term to appoint a new Chairman of the Federal Reserve Board.
- The Fed's budget is not published in the U.S. Government Budget, even though it spends over $1.5 billion per year.
- And, even though the Federal Reserve engages in more than $1 trillion in transactions in the money markets each year, most of these activities are exempt from audit by the GAO or any other outside agency.

The Federal Reserve Reform Act would address these problems by making the following modest changes in the practices and procedures of the Federal Reserve:

(1) It would require the Secretary of the Treasury, the Chairman of the Council of Economic Advisers, and the Director of the Office of Management and Budget to meet three times a year on a non-voting basis with the Federal Open Market Committee, to consult on monetary and fiscal policy. This would open a formal channel

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of communication between the policy-makers in the White House and the policy-makers at the Federal Reserve.

(2) It would allow the President to appoint a Chairman of the Federal Reserve Board (with the advice and consent of the Senate) one year after taking office, at the time when the first regular opening would occur on the Federal Reserve Board. This would make the Fed Chairman's term basically coterminous with the term of office of the President of the United States.

(3) It would require the FOMC to disclose immediately any changes in the targets of monetary policy, including its targets for monetary aggregates, credit aggregates, prices, interest rates, or bank reserves.

(4) It would permit the Comptroller General to conduct more thorough reviews and studies of Federal Reserve operations, by removing selected current restrictions on GAO audits.

(5) It would require that the Federal Reserve's annual $1.5 billion budget be published in the Budget of the U.S. Government. The Fed would submit its budget for the current year and the two following years to the President by October 16 of each year, and the President would be required to print the Fed's budget in the Government Budget without change.

The Monetary Policy Reform Act would add a sixth change to this list, by making the duly-appointed public officials on the Board of Governors of the Federal Reserve solely responsible for the conduct of monetary policy.

During the last Congress, the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance, and Urban Affairs conducted a hearing on the Federal Reserve Reform Act, and I would like to submit my statement from that hearing for the hearing record.

In summary, the status of the Federal Reserve Bank presidents is an anomaly in our system of government. They do not go through the normal appointment process but, nonetheless, they participate in monetary policy decisions through their membership on the FOMC, where they cast five of the twelve votes that determine monetary policy and interest rates. In earlier times, when the Fed was less powerful, this was not a major concern. But today, it is widely recognized that the Federal Reserve is the chief way the government influences the economy. Decisions made by policy-makers at the Federal Reserve affect the lives and well-being of all Americans. Power without accountability does not fit the American system of democracy. We have changed the Federal Reserve in the past. It is now time to move further and take the next step to make the Federal Reserve more accountable. Monetary policy today must be the responsibility of properly-appointed public officials, who are accountable to the American people for their performance in office. The Monetary Policy Reform Act of 1991 would apply this principle of democracy to the Federal Reserve.

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STATEMENT OF BYRON DORGAN, MEMBER, U.S. HOUSE OF REPRESENTATIVES, NORTH DAKOTA, AT LARGE

Mr. DORGAN. Senator Sarbanes, thank you very much.

You and my colleague, Congressman Hamilton, have covered this subject in some detail and I think with great clarity.

In an act of mercy, I shall be very brief, and I'm going to be brief because I can probably add very little to the two excellent statements.

The recession that we now experience follows on the heels of a decade of almost dangerous and reckless fiscal policy, such that we don't have much capability in fiscal policy to respond the way Congress would have traditionally responded to recessions.

The result is that monetary policy has to bear the burden and carry much of the load. And as a result of that, most all of the spotlights are now shining on the same spot in this town with respect to what is being done to try to respond to the recession.

That spot that the spotlights are shining on is the Federal Reserve. The Fed is the center of attention at this moment.

This is, it seems to me, an appropriate time to be discussing the Fed because of that. If you read economic history and financial history in this country, you discover that in the last century, the subject of money, interest rates, and related policies were widely discussed as political topics in barber shops and bars all across this country.

In this century, we've not seen much of that, largely because we created early in this century the Federal Reserve Board, which has grown to become an institution shrouded in some mystery, operating in some secrecy. I think a lot of people don't quite understand how monetary policy works or how, if they chose to, they could impact or affect monetary policy.

For that reason, I think this kind of a discussion is an appropriate discussion at the appropriate time. At a time when the American people are talking about and thinking about institutions in Washington that need reform and need change, it is also an appropriate time for us to discuss what might be done to change the role of the Fed in a constructive way.

As Congressman Hamilton indicated, we have introduced previously a reform bill that has four or five elements that we think are very important, and this travels with that and is complementary to that.

Very simply, what we believe is that those who are making public policy in this country ought to be accountable to the set of public interests for which they operate.

There is often a conflict between public policy and various sets of private interests. And there has not been a separation of those two elements in the decision making at the Fed because of the way that the Federal Open Market Committee works.

I think Congressman Hamilton said it best when he said, we simply must change that if we're going to have people making public decisions who are ultimately accountable to the public for public policy that results from those decisions.

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For that reason, I fully support the statement of Congressman Hamilton and yourself, Mr. Chairman. I hope that we can move forward on this legislation.

Let me make one final comment.

Anytime anyone in this town whispers anything about the Federal Reserve Board, there are armies, literally legions of people who will rush forward and say, this Fed-bashing must stop.

Let me assure you that Congressman Hamilton and I are not Fed-bashers.

Let me also assure you that the Federal Reserve is a public policy institution created by, developed by the U.S. Congress for the people of this country. And there is nothing wrong, in fact, it is essential, I think, at various times for us to review its function and determine how it can and must change to be appropriate for today.

So, we do this in a very constructive way and are very heartened by your holding this hearing today.

Thank you, Mr. Chairman.

[The complete prepared statement of Representative Byron Dorgan follows:]

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TESTIMONY OF
THE HONORABLE BYRON L. DORGAN
BEFORE THE SENATE BANKING COMMITTEE
November 13, 1991

Mr. Chairman and members of the Senate Banking Committee, I am pleased to address you today on proposed legislation that resurrects a fundamental principle in our democracy that individuals making public policy decisions should be accountable to the American people.

In early August, I joined Congressman Lee Hamilton of Indiana in introducing the "Monetary Policy Reform Act of 1991" that would place the responsibility for this country's most important monetary policy decisions solely in the hands of the Federal Reserve s duly-appointed Board of Governors. Companion legislation was introduced by two distinguished members of this Committee, Senator Paul Sarbanes (D-MD) and Senator Jim Sasser (D-TN).

One half of this country's economic policy -- monetary policy -- is made primarily by the Fed Reserve s Federal Open Market Committee (FOMC). The FOMC consists of the seven members of the Board of Governors and the twelve regional bank presidents who vote on critical monetary policy decisions that affect the nation's economy. As a result, the FOMC has enormous power over the direction that our economy is heading.

The Board of Governors are appointed by the President and confirmed by the Senate Inexplicably the regional bank presidents -- who serve the private interests of their banks -- are not appointed by the President or confirmed by Congress. Yet, they are entitled to 5 votes on a rotating basis that vitally impact our national economy. Consequently these private individuals wield enormous power over the lives of every American, but they can't be held accountable like other government officials.

This legislation is intended to increase the Fed's accountability to the American people by ensuring that its voting members are limited only to those officials who have been duly appointed and confirmed by the President and the Senate, respectively.

Specifically, the "Monetary Policy Reform Act of 1991" would dissolve the FOMC and replace it with a Federal Open Market Advisory Committee (FOMAC). As members of the newly-created FOMAC, the bank presidents would continue to advise and consult with the Board of Governors about the course of monetary policy. But voting rights would be left only to the duly-appointed Board of Governors who can ultimately be held accountable by the President and Congress.

It shouldn't be a surprise to hear that limiting the power to make monetary policy to only duly-appointed government officials is the accepted practice around the world. One recent survey of central bank systems in other foreign countries indicates that private individuals may hold advisory positions, but they can't vote on specific items of monetary policy.

The lawmakers who wrote the original Federal Reserve Act of 1913 labored to ensure that the Fed would be an accountable government institution. While the Act was being considered, President Wilson emphasized the necessity of keeping the conduct of monetary policy in the public domain. And we've attempted to resurrect this worthy democratic goal by eliminating the votes of the bank presidents who are neither appointed by the President nor confirmed by the Senate, but exercise enormous power over the course of this nation's economic future.

Again, I appreciate the opportunity to testify before this Committee about this important initiative to make the Fed, in my judgment, a more meaningful player in our democratic system.

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Senator SARBANES. Well, thank you very much.

I want to pursue with you and Congressman Hamilton that last point. Obviously, any change, then, immediately runs into this firestorm of comment that you're going to "compromise the independence of the Federal Reserve." You're going to politicize it, and so forth.

Of course, there are other central banks in other countries that are perceived to be very independent and exercise a very tight rein, whose members are selected through an indirect public process, not through direct election by the people, but through selection of those who have been selected by the people.

I just wanted to go over this chart with you because I think it's very instructive. I wanted to talk about a survey made by the House Banking Committee to sort of set the stage.

This is the Federal Open Market Committee. The seven members of the Board of Governors are on the Federal Open Market Committee. Of course, they make these very fundamental monetary policy decisions in this country.

Those seven members are nominated by the President and confirmed by the Senate. So they have a public accountability. They do get 14year terms, longest we give anyone other than the lifetime tenure we give to Federal judges.

But, nevertheless, the theory is of a public accountability.

There are then five voting bank presidents who make up the 12 member Federal Open Market Committee.

I might note that there are a couple of vacancies right now on the Board of Governors, so the bank presidents actually have an equal weight currently.

Now these bank presidents come out of a process of the 12 Federal Reserve banks. Each has nine directors. They have three class A directors drawn from banking, three class B drawn from business, three class C drawn from the public.

These A and B directors are elected by the commercial bank members. So six of the nine are picked by the member banks of the Federal Reserve Banks. The three public members are appointed by the Board of Governors. And then, of course, they elect the bank presidents.

The New York Fed always serves and the others come on by rotation.

So what you have is you have bank presidents elected by their board of directors. The board of directors are essentially elected by the member banks. And then the bank presidents end up over here on the open market committee making very important public policy decisions. But all of this sector, in effect, is private. This is public here.

Now what the House Banking Committee found in a study of the composition of the board of directors, they found that 70 percent of the directors of the regional Federal Reserve banks were current or former members, that amongst the 72 class A and B directors—in other words these six in each bank, 12 banks, 72 of them—there was one African American, three women, no Hispanics, no Asian-Americans.

It's a white male bastion, if there ever was one.

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That among the 32 class C directors, half were former bankers and there were no labor or consumer representatives.

So that you have a very disproportionate pool, in a sense, you're drawing from.

What is your response to the assertion, first, that the presidents bring an important regional perspective to the FOMC meetings, and that we would lose that perspective with the changes proposed in this bill?

Mr. HAMILTON. Mr. Chairman, Senator Sarbanes, I think it is important to have a regional perspective brought, and we don't wipe that out. What we do is bring that regional perspective to the front by the advisory committee.

So that's not going to be lost in this bill at all.

Senator SARBANES. So the seven Board of Governors would have—the regional bank presidents would still come and advise and consult with them. So they'd have the benefit of that point of view.

It's just that five of the 12 would no longer be casting votes.

Is that correct?

Mr. HAMILTON. That's correct.

Senator SARBANES. Now what's your response that this would reduce the independence of the Fed, supposedly reduce the independence of the Fed?

Mr. HAMILTON. I think, as Congressman Dorgan said, it certainly is not our intention here to reduce the independence of the Fed.

Anytime anybody makes any kind of a suggestion for even the most modest kind of change in the structure of the Federal Reserve, you're immediately confronted with the charge that you're trying to undermine the independence of the Fed.

We're not trying to do that. This is an extraordinarily modest change. All we're doing is bringing the Fed in line with normal principles of accountability that represent in our Government.

So we're not trying to—we don't want to undermine the independence of the Fed. But to be independent, the Fed does not have to be free and clear of accountability, it seems to me, and that's what we're trying to do, bring somewhat more accountability into the system.

The Fed can't be independent of the basic principles of democracy.

And may I say that measuring this kind of a step in the structure of the law compared to the kind of statements that President Bush has made with respect to monetary policy in which he has engaged, and his administration has engaged over a period of time in a lot of jawboning of the Fed, and I might say, effectively.

On one occasion he said it on 1 day, and within 2 days, the Fed had reduced two interest rates. That is far more politization of the Fed than this modest bill, it seems to me.

I don't necessarily mean that the President was off-base in that. It seems to me the President has the right to express it.

Senator D'AMATO. Would the Congressman suggest that possibly, a little politization might be in the national interest?

Mr. HAMILTON. I must say, you and I, I know, Senator, share the view that decisions are made in this country through the political process. I don't rebel in horror at the idea of politics.

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Senator SARBANES. Take a judge. We have an independent judiciary. We don't feel that in order for that judiciary to be independent, that the judge has to seat next to him to cast half a vote or participate in the process someone who's come completely from the private sector.

We don't go quite as far with the Federal Reserve Board. We give them a 14 year term.

If that's not a term designed to develop independence—and of course, the whole rationale is they have a certain independence.

What you've done is you've carried independence in the making of public policy decisions, it seems to me, to such an extreme that you've brought into it private parties who are making public decisions, which, as both of you have pointed out, is something that's really antithetical to democratic principles.

Mr. DORGAN. Mr. Chairman, no one who's very thoughtful is going to allege this compromises the independence of the Fed. There will be some who allege it, but it is not a very thoughtful position.

This does nothing with respect to independence. We don't alter the question of who is appointed and who is confirmed to make decisions at the Fed with respect to the Board of Governors.

What we are saying is that, as a matter of principle, those who are beholden to private sector interests and are not accountable in any way to the public sector ought not be making public sector decisions that have great consequence for the public as a whole.

If I belong to the Fed, if you belong to the Fed, if we are part of that fraternity, we wouldn't ever want anybody doing anything that interrupted our lives, because the Fed has become what it was never promised to be, if you go back and read the history of its creation. And it's a wonderful thing for those who are in it.

And I'm not suggesting radical overhaul here today. I am saying that there are some steps that we must take, and I think beyond this bill, we need to go to the other bill that Congressman Hamilton and I have introduced, that make monetary policy and the construction of it in this country much more coherent and much more thoughtful than it is today.

Our appearance here is not to be here today to criticize the current practice of the Fed with respect to interest rates or other things as well. We're here to talk about process and the way the institution works.

I understand the critics will say this is Fed-bashing and deals with the independence, but it's simply not the case.

Senator D'AMATO. Oh, a little bashing doesn't hurt now and then.

[Laughter.]

Senator SARBANES. We have a vote on now. I'm going to yield to my colleagues for any statements they may have and any questions. I think we should finish with this panel before we leave for the vote so our two colleagues will be able to return to their duties on the House side.

Senator D'Amato?

Senator D'AMATO. Mr. Chairman, it's always good to see my good friend, the distinguished congressman, Congressman Hamilton. Congressman Dorgan, good to see you.

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I really think that this business about independence can easily be overstated. I think Congressman Hamilton quite correctly pointed out that there certainly is a relationship whether we call it jawboning or informing Congress has a right to let the so-called independent regulators know what we believe.

The Fed's not always in synch. We've had Alan Greenspan here numerous times. Going back a year and a half ago, I was pleading with him to lower interest rates—telling him to wake up and understand what was happening. He was concerned about inflation. I told him to find out about what was happening in the real world.

I think the proposal being discussed today has some real merit to it. I'd like to put a statement in as if read in its entirety.

Senator SARBANES. The statement will be included in the record.

Senator SASSER. Well, thank you, Mr. Chairman. I just want to welcome my good friends, Congressman Hamilton, and Congressman Dorgan, before the committee this morning. I'm pleased to be cosponsoring this legislation, along with them in the House of Representatives, and with you, Mr. Chairman.

I have a statement which I would like to have included in the record. I have no questions at the moment, although I will read the statements of both Congressman Hamilton and Congressman Dorgan with great interest.

Thank you.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, thank you for scheduling this hearing on legislation introduced by Senator Sarbanes and myself. I consider the changes contained in The Monetary Policy Reform Act extremely timely considering the seriousness of the current recession. The purpose of our bill is to ensure that those individuals involved in formulating monetary policy are accountable to the American public. And that the Federal Reserve can operate quickly and efficiently in responding to market developments.

The Federal Reserve's open market committee consists of the seven members of the Board of Governors and five district bank presidents who serve on a rotating basis. Unlike their board member counterparts, the bank presidents are not public officials who are publicly appointed. Instead, they owe their allegiance to the interests of commercial banks in their districts. Nevertheless, bank presidents participate in important monetary policy decisions as members of the Federal Open Market Committee, which has complete control over the purchase and sale of Government securities.

Mr. Chairman, under the current Fed system, economic decisions vital to every homebuyer, small businessmen, farmer and consumer in this country are being made by individuals who are in no way held publicly accountable. As private citizens in a public role these Fed bank presidents wield a power unmatched in any other Government agency. Indeed, there is considerable evidence that the composition of the Federal Open Market Committee as unconstitutional.

We as duly sworn members of the U.S. Senate have an obligation to uphold the constitution. If we believe that the current structure

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is unconstitutional, notwithstanding any court ruling, we have a duty to change it.

The Monetary Policy Reform Act would dissolve the Federal Open Market Committee and in its place create an advisory committee. Bank presidents would continue to act as consultants but would not retain voting power.

Last fall, it was widely reported that disagreements between the bank presidents and the members of the Board of Governors, in particular Chairman Greenspan, were keeping the Fed from making critical monetary policy changes. I'll be blunt, the Fed was not able to act, or just plain did not act, at a critical time and the economy fell over into the abyss. The recession, we now know began in July 1990, but the Fed did not effectively begin to reduce interest rates until December 1990. The Fed waited far, far too long, and apparently its delay was exacerbated by the posture of the reserve bank presidents.

I can think of no more public a responsibility that coordinating governmental policy to fight this recession. Yet under our current system Government policy that is so important is subrogated to the interest of private banking interests.

I thank the chairman for this opportunity to speak on what I consider a very important issue and I look forward to hearing from this morning's witnesses.

Senator SARBANES. Well, gentlemen, thank you very much. We certainly appreciate your testimony. We appreciate the leading role you've taken in trying to address this issue.

We haven't developed it much, but there is a report that the Joint Economic Committee—a study that was submitted to the Joint Economic Committee which contrasts how we do it in this country with how it's done in the other major industrial countries.

And in a number of those countries in which the independence of their central bank is clearly recognized, but they still do not let private parties play this decision making role, which is taking place here.

I know you have other changes you also wish to make in your broader bill, but I think this is a very important first step in bringing important public accountability to these monetary policy decisions, which right now are, in some respects, the critical ones for our economic situation.

Thank you all very much.

Mr. HAMILTON. Thank you very much.

Mr. DORGAN. Thank you.

Senator SARBANES. Mr. Tobin and Mr. Martin, we're going to recess briefly to go and vote because the second set of bells are about to ring. And then we'll return and begin with this panel fresh after the vote.

[Recess.]

Senator SARBANES. Gentlemen, we apologize for the delay, but there turned out to be two votes, one right after the other, and we stayed, obviously, for the second vote, but hopefully, we won't be interrupted for a period of time here.

So we'd be happy to hear from you. Jim, why don't you go ahead. Or have you——

Mr. TOBIN. We haven't consulted on that, whichever you want.

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Mr. MARTIN. I have not had the prize winning record of my colleague.

[Laughter.]

Mr. TOBIN. Different prizes, different fields.

Senator SARBANES. Well, you're both honorable. You've both held important Government positions.

All right. Why don't we hear from professor Tobin and then we'll hear from Preston Martin.

STATEMENT OF JAMES TOBIN, STERLING PROFESSOR EMERITUS OF ECONOMICS, YALE UNIVERSITY, NEW HAVEN, CT

Mr. TOBIN. Well, thank you, Senator Sarbanes.

I'd be glad to testify on this bill and this whole problem. Actually, it's an old crusade of mine, from time to time. Two years ago, I testified on the House bill that Congressman Hamilton referred to this morning when that was first proposed. I know that at least on one occasion further back, I called attention to this problem at hearings here.

So I think, as you said, and as the preceding witnesses also emphasized, there is a real problem of democratic legitimacy in the anomalous position of the Federal Reserve bank presidents.

I'd like to make clear that I have nothing personal against Federal Reserve bank presidents. I've known a lot of them in my time and have been friends with them, though not always agreeing with them. And I do think they bring important, useful information to the deliberations of the Federal Reserve, the FOMC, and the Board of Governors.

I do think that, in my experience, Federal Reserve bank presidents would more often tend to be "tighter" than governors in their view of monetary policy. I don't remember occasions when it was the other way around, when presidents were in favor of easier policy than the governors were.

Senator SASSER. Professor Tobin, I'm sorry to interrupt you. Could you pull the microphone just a little bit closer. I'm having difficulty hearing you.

Mr. TOBIN. Sorry.

Senator SASSER. Thank you.

Mr. TOBIN. It's particularly important to worry about this matter at this time because fiscal policy, which used to be regarded as a co-equal instrument of Federal macro-economic policy, has been disabled and is hors de combat, so to speak, because of the history of fiscal policy in the last 10 years.

So monetary policy is the decisive policy in determining what goes on in recessions and recoveries, in the short run fluctuations of the economy.

Regarding the status of the bank presidents, as I see it, there are two ways to go to resolve the problem. One is the method of the bill before you, S. 1611, which is to abolish the Federal Open Market Committee and thus deprive bank presidents of votes on monetary policy. S. 1611 would establish an advisory council of the 12 bank presidents, which would from time to time advise the Board of Governors, in whom the full responsibility for policy would be placed.

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The other way, which I have advocated in the past, is to regularize the position of the bank presidents as Government officials. It would make them legitimate, so to speak, by having them appointed by the President and confirmed by the Senate in the same manner as the governors. Then it would not be anomalous for them to have votes on monetary policy matters.

I think that route is somewhat preferable, although I would certainly endorse S. 1611, if it was the only choice on the menu that would resolve this problem.

I think that we should move in the direction of making the district banks appear to be as they should be, agencies of the Federal Government, rather than private banks, as they were set up in the first instance.

My suspicion is that the presidents will continue to be quite powerful under the bill that's before us today. The advisory council that is set up would, in effect, when it meets with the governors, be the Federal Open Market Committee without the presidents' having votes.

And I can well imagine that those meetings would occur eight times a year at the same time as the governors are making their periodic reconsiderations of monetary policy. While the bank presidents won't have votes, they will still have considerable influence, I think, in the determination of policy. It might be preferable if they had been appointed and confirmed so that they were legitimate Federal officials.

And I might add, paid as such, rather than as presidents of private banks. Their salaries should be comparable with those of the Board of Governors themselves.

A number of the problems addressed this morning by Congressman Hamilton and Congressman Dorgan were addressed in the bill on which I testified a couple of years ago, then H.R. 3512, now H.R. 1130. They are not covered by S. 1611, but, I think some of those problems should be taken up as well.

One of them that I think has been important over the years, and on which there's been a long history of attempts to rectify, is the accidental lack of synchronization between the term of the governor who is appointed Chairman of the Federal Reserve for 4 years and the term of the President.

It's purely accidents of history, unintended, that have made the terms begin where they do now, in the third year of a presidential term. Further accidents could happen if a chairman resigned before his 4 years were over, because of the provision of the present law that the term of a chairman will be 4 years from whatever date he is appointed, rather than completing a prescribed term. I think that bringing the term of the chairman to start 6 months or 1 year after the term of the President begins would be an important step.

There are some other problems of governors of the Federal Reserve that would be good to resolve.

Fourteen-year terms—you, Mr. Chairman, were speaking of their unusual length before the recess. Fourteen-year terms seem awfully long to appoint anybody into positions of such power and importance in regulating the economy. I would think that that could be reduced to 10 or maybe even to 7 years.

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I also believe that the chairman of the Council of Economic Advisers and the Secretary of the Treasury and the Director of the Office of Management and Budget should have a greater opportunity to present their views about monetary policy to the policy making bodies of the Federal Reserve every time an open market committee or Board of Governors meeting is held for the purpose of reconsidering policy. This should occur not just three times a year, as I think H.R 1130 requires, but regularly.

For example, if the FOMC were to continue as it is, or if a substitute for it like the advisory council were enacted, then I think it would be desirable to have those three key economic officials of the executive present.

Right now, it seems to me an anomaly that, in the FOMC where there are seven nonvoting bank presidents who have not been appointed by the President, these other important economic officials of the Executive Branch are excluded. They should have the chance to present the administration's view about what economic policies should be and what the place of monetary policy in them should be, even as nonvoting members.

I'm not suggesting that they should be voting members of the monetary policy making body, whether it be the board or the FOMC. But I think they should have a chance to present their views to the whole FOMC or the whole Board of Governors and advisory council.

Right now, they have informal arrangements, I know, between the Treasury and CEA and the Chairman of the FED. I think it's important that they be allowed to present their views, the administration's views, about macroeconomic strategy to the entire monetary policy decision body.

If there were reforms of these kinds, a minor oddity that could be remedied is the anomalous position of the Cleveland and Chicago district banks. They have a preferred frequency of being voting members in the rotation, another historical accident.

I do believe that the Federal Reserve Bank of New York should continue always to be a voting member, if any presidents have votes.

I didn't read my script because I assumed that you could read it at your leisure. But let me emphasize again that I think that decisions of the Federal Reserve are the most important decisions in regard to the operation of the whole economy, what we economists call macroeconomic decisions, the most important decisions made by anybody, in the Federal Government or anywhere else.

The President and the Congress are held responsible for the macroeconomic performance of the economy by the electorate. They're held responsible if unemployment is too high, inflation is too high, or whatever they may be. They are the ones who bear the brunt of responsibility, and I think that's quite proper.

But many of the decisions which determine those results are made not by the President and the Congress, but by the Federal Reserve, the FOMC or the Board.

To say that you don't want to politicize those decisions is to say that you don't want the people who make them to be accountable to elected officials and thus to the electorate.

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I don't think you can put monetary policy to one side as if it were a purely technical matter. It may have been the idea, when the Federal Reserve Act was passed in 1913, that financial liquidity is a technical matter. No one thought of it as economy wide policy.

But as it has turned out, it is economy wide policy, the decisive and crucial policy. And we've seen decisions of immense repercussions for the whole society and the world made by the Federal Reserve.

I'm not saying they were made wrong. Maybe sometimes yes, sometimes no. But the decision to have a deep recession in 1974–75, and an even deeper one in 1980 through 1982, those were Federal Reserve decisions. Their priority was to do something about inflation at whatever expense in unemployment and low production occurred.

Senator SASSER. Excuse me.

Mr. TOBIN. And maybe that was good policy, but it certainly was a political act to decide to do that.

Senator SASSER. Professor Tobin, let me ask you a question. I misunderstood your last comments.

Did you say that the Fed decided to have a recession in 1978 and then 1980 and 1981?

Mr. TOBIN. I said in 1974–75, and then in 1980 to 1982.

And then the Federal Reserve decided at the end of 1982 to turn the economy around into recovery. Right now, as we know, we are in a debate about where to go from here, which will be largely decided by the Federal Reserve. Again, the question is whether vigorous recovery will be promoted by the Federal Reserve or whether that will take second rank behind a determination to reduce the inflation rate even further than it already has fallen.

Those are the very most important matters of political economy. And to say it's political to make decisions about them is just saying that they are responsibilities of democratic Government and that whoever makes them should be accountable and legitimate agents of the electorate.

Senator SARBANES. Very good. Before I turn to Mr. Martin, I just want to quote. You've sort of touched on it, but two sentences from your prepared statement, all of which will be included in the record.

> The most important decisions of macroeconomic management in the United States and, indeed, in the world, are made by the Federal Reserve.

And then later in the paragraph, you say:

> The meetings of the Federal Open Market Committee, held 8 times a year, are the world's most decisive regular deliberations on Government economic policy.

Just to underscore, in a sense, the importance of what we're talking about.

Mr. Martin?

[The complete prepared statement of James Tobin follows:]

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MONETARY POLICY REFORM ACT OF 1991 (S. 1611)

Senate Committee on Banking, Housing, and Urban Affairs
November 13, 1991

STATEMENT OF JAMES TOBIN
Sterling Professor Emeritus of Economics, Yale University

The most important decisions of macroeconomic management in the United States, and indeed in the world, are made by the Federal Reserve. For good or ill, its monetary policies determine the path of the American economy and strongly influence other economies throughout the world. Interest rates, stock and bond prices, exchange rates, trade balances, inflation rates, GNP growth, and unemployment rates, to mention only the most important variables, depend on the Fed's actions. The meetings of the Federal Open Market Committee (FOMC), held eight times a year, are the world's most decisive regular deliberations on government economic policy.

Of course, many other government policies have substantial economic effects. They concern taxes, regulations, public investments, transfer programs, commercial policies, and other familiar items on the agenda of Congress. For the long run, these may be more substantial than anything the Fed can do. But for management of aggregate demand in the short run, for stabilization of the economy against cyclical fluctuations, for avoidance of recessions and inflations, the Fed's monetary policies are virtually all the federal government has. That is true as we meet today. Recovery from the economy's present doldrums depends almost wholly on Federal Reserve monetary policy.

In the past, fiscal policies, as embodied in the overall demand-side impact of the federal budget, could be regarded coequal to monetary policies. But the extreme deficit-spending policies of the 1980s have severely limited the possibility of using the budget as an instrument of short-term stabilization. For most of the past decade federal budget deficits have been an unwelcome fixture of the environment in which the Fed makes monetary policy.

S. 1611, like a somewhat similar bill (H.R. 3512) on which I testified before your sister committee of the House two years ago, raises a fundamental issue of democratic government. The issue is: Should the makers of the most

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important economic policy decisions of the federal government be so far removed from responsibility to the electorate as is the Federal Open Market Committee?

When the Federal Reserve System was founded in 1913, it was envisaged as an important financial reform and as insurance against financial panics, not as an agency controlling the whole economy. Even in 1935, when the currently governing legislation was enacted, no one imagined the decisive economic role the System has now come to play. Indeed in those days the electorate had not yet assigned to the President and Congress the responsibility for macroeconomic performance now taken for granted.

The FOMC has twelve members, seven Governors and five Federal Reserve Bank Presidents. Also present at the meetings and participating in the discussions are the seven Presidents who at the time are not voting members. (Membership rotates among the Banks, although not equally. The New York President always has a vote and the Chicago and Cleveland Banks have votes in alternate years; the others are two years off and one year on.) Nobody besides these Federal Reserve officials and their staffs attends the meetings.

The 14-year terms of the Governors can perpetuate the influence of the Presidents who appointed them long after the Presidents themselves have left office. There may be as few as two appointments in a Presidential term, two of twelve members of the decision-making body, the FOMC. Usually there are more, because Governors resign before their terms are up and the tenures of their replacements are limited to the time remaining in the 14-year terms. A case can be made, I think, for reducing the terms to ten years and the size of the Board of Governors to five. This subject is not addressed in S. 1611, but it would be a good occasion for making this reform.

H.R. 3512 in 1989 proposed to rectify at long last the timing of the four-year term as Chairman of the Governor so designated by the President. The timing is now accidental. No one intended that the President should have to wait for 30 of the 48 months of his term before choosing, with the advice and consent of the Senate, a Federal Reserve Chairman. That is when Chairman McCabe happened to resign in 1951, and the 1935 Act provides that a new Chairman shall serve for four years from date of appointment. Future accidents might shift the time again, maybe nearly to the end of the Presidential term, maybe to just after inauguration. It is surely a good idea to set the time rationally and permanently, and to allow for some overlap into the new

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Administration. Six months seems to me long enough, but one year, as the previous bill provided, would work well too. This matter is not covered by S. 1611, but I hope it will be taken care of by legislation before another Chairman's term expires.

The major violation of democratic legitimacy is the power of the Presidents of the district Federal Reserve Banks. Although they participate in definitive votes on crucial economic policy, they are neither appointed nor approved by elected officials in either executive or legislative branches of government. Technically, legally, the Banks are private corporations owned by the member banks of the district. Thus the Presidents are selected by the Directors of the Banks, subject however to the approval of the Board of Governors. In practice, experience suggests, the Chairman can have considerable influence. In keeping with the legal fiction, the Bank Presidents are paid like private bank executives rather than federal officials. Appointed for renewable five-year terms, they generally have long tenures.

The Bank Presidents should not have it both ways. The regional information and perspective the Bank Presidents can bring to the FOMC doubtless have value. But if they vote like Governors, they should be appointed (and paid!) like Governors. They should be appointed by the President of the United States with the advice and consent of the Senate. The District Bank Board of Directors could make nominations, the Chairman and other Governors likewise. If the Bank Presidents are appointed (and paid) as they are now, then they should not be allowed to vote even if they attend FOMC meetings.

S. 1611 would correct the anomaly by abolishing the FOMC and placing monetary policy solely in the Board of Governors. The Bank Presidents would be members of a Federal Open Market Advisory Council. At the Council's meetings the Governors would get the Bank Presidents' advice, but the Presidents would have no votes on policy. This does the job of assuring that policy is made by and solely by persons appointed by and accountable to democratically elected officials.

However, I suspect that the reform might be more formal than substantial. The new Council would doubtless meet at the same frequency the FOMC now is convened, and those times would be the regular occasions on which the Board would reconsider monetary policy. Indeed the policy-making and voting sessions of the Board might well take place with the Council present.

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For this reason, I favor the alternative approach of making the Bank Presidents federal officials like the Governors, with the same terms, confirmation procedures, and emoluments. The FOMC could continue, with five of the Presidents having votes on a rotating basis. The President of the New York Bank would always have a vote, and the other four would rotate without any Bank having preferred status.

I believe it is important that the Administration have the opportunity to explain its economic strategy and outlook to the Fed. It is important because the President and his Administration have the ultimate responsibility to the nation for economic performance. Direct relationships to Federal Reserve actions arise from the Treasury's responsibilities for public debt management and for international financial and monetary relations. I would provide that the three executive branch officials -- Treasury secretary, CEA chairman, and OMB director -- participate without votes in FOMC meetings. There should be communications between them and the whole FOMC, not just the Chairman. These should occur routinely at the regular action meetings of the FOMC. If the parts of those meetings at which votes are taken exclude non-voting participants, they should exclude the non-voting Bank presidents as well as the Executive officials. If the S.1611 solution is followed, the Administration officials should be present at meetings of the Advisory Council and should be guaranteed opportunity to present their views to the full Board eight times a year.

All these proposals are quite modest. They leave the Federal Reserve with considerable independence of the Executive, much more than most other central banks. Nevertheless they are routinely condemned as bringing politics to bear on monetary policy. Politics? In a representative democracy? Think of it! Economic performance necessarily involves political choices; it is hard to imagine issues of greater moment.

Consider, for example, the two big Federal Reserve policy decisions of the last ten years. In 1979 Paul Volcker and his colleagues decided to restrict money growth and bring about recession in order to overcome the inflation accompanying the second oil shock and the Iranian revolution. That policy eventually brought unemployment nearly to 11 percent and plunged many firms and financial institutions into bankruptcy. In late 1982 it was the Fed again that decided to suspend the anti-inflationary crusade and promote recovery although the inflation rate was still 5 percent. I am not arguing

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here whether either decision was right or wrong. I do argue that policies of such economic and political gravity should not be adopted by the FOMC all by itself.

Macroeconomic policy-making is a two-way street. Had there been more consultation about the mixture of fiscal and monetary policies between Federal Reserve and Administration in the early 1980s, we might have had a more moderate fiscal policy and a somewhat easier and lower-interest-rate monetary policy. That strategy would have been very advantageous to the nation.

This year, there has been considerable debate whether monetary policy should give priority to prompt and vigorous recovery or to reducing inflation to zero. To first course would require a low-interest-rate expansionary monetary policy, the second less accommodative policy and tighter credit. With the second priority, the economy would remain stagnant and slack for 1992 and perhaps longer. A split on this issue within the FOMC has been reported, and was evidenced by at least one announced dissent from the interest rate reductions decided earlier this month. This is not just a technical issue. It's hard to imagine a policy decision of greater political moment.

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STATEMENT OF PRESTON MARTIN, CHAIRMAN OF THE BOARD AND CEO, WESTFED HOLDINGS, INC., MARINA DEL RAY, CA, FORMER VICE CHAIRMAN, FEDERAL RESERVE

Mr. MARTIN. Thank you, Mr. Chairman.

Senator SARBANES. We're very pleased to have you here, sir. We're looking forward to hearing from you.

You were on the inside, so we're looking forward to hearing from you here.

Mr. MARTIN. Yes, sir. Thank you very much. I appreciate the opportunity to share with you some experience in monetary policy making. I'm here to support. S. 1611 for a number of reasons which I will briefly indicate today.

I would ask the courtesy of my statement being put in the record and I will skip large sections of it, Mr. Chairman, knowing the pressures of time on yourself.

Senator SARBANES. Well, we'll include the full statement. I've looked at it quickly. It's a very good statement, so don't feel compelled to overskip it, so to speak. We appreciate your compressing it a bit, but we also want to make sure we put your message on the public record here.

Mr. MARTIN. Thank you, Mr. Chairman.

To prepare for my testimony today, I viewed my 49 months as a governor and vice chairman of the Fed. And I reread the summaries of the Federal Open Market Committee, the FOMC, results at the Board of Governors.

I would also refer a couple of times to my experience at the Federal Home Loan Bank Board where I served 4 years as chairman.

The record of policy making of the Fed over almost eight decades has been a most outstanding one. In the post-World War II period, I believe that only the Bundesbank in Germany can boast of such an outstanding record of fighting inflation and, sometimes contradictorily, fostering economic growth.

For those two central banks, the independence of the entity from the U.S. Treasury, on the one hand, and the Federal Republic Ministry of Finance, on the other, has been a substantial advantage.

Like any human institution, the Fed has made its mistakes. But the Fed board members themselves have a degree of personal security derived from the 14 year terms we've been talking about and from a traditional of professionalism and integrity, traditions which often are lost in a media-oriented world today.

And I'm reminded that a board member, in my experience, has been very careful not to go over to the White House and confer with the staff of the President, not to be over at Treasury, except in the regular meetings of Treasury and Fed appointees.

The FOMC members have an outstanding record of voting their consciences, not the politics of the White House from which their appointments originated, in that 78 year history. The same behavior characterizes the Bundesbank members, all of whom are political appointees.

Permit me to comment, Mr. Chairman, on the role of this committee in reviewing appointments to the Board itself.

My background includes teaching financial institutions and monetary policy for 20 years or so, including University of Southern

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California, and assignments in Turin, Italy, and Karachi, Pakistan. My Ph.D. is in monetary economics, although, unfortunately, not from the gentleman on my right.

If I had it to do over again, Jim, it might be different.

So I do appreciate academic credentials for board membership. However, my 4 years on the Fed Board convinces me that it is clearly in the public interest to confirm board members who have a variety of "real world" experience, experience in the business arena, the financial markets, and time spent as regulators—all are useful at the Beard, even indispensable.

A diversity of geographical backgrounds is the second criterion. The United States has now endured the increased impact of regional business cycles which have been notable—first, the middlewestern "Rust Belt," then the farm States' crisis, and then the reversal of the "Massachusetts Miracle" all over New England.

Today, greater New York and its environs are suffering, and the growth rate in once booming California has yielded to normalcy, just ordinary growth.

I respectfully recommend that this committee return to the criterion of the Federal Reserve Act which mandates genuine geographic diversification of the Board membership itself.

Given the degree of success of the U.S. central bank, why reconstruct or reform the institution?

Under Chairman Greenspan's chairmanship, a new collegian nature of the Board has been fostered. Both board members and Fed bank presidents have been heard from, both far more than was possible during Paul Volcker's regime during which I served.

This is not an indication of undue devisiveness, in my experience.

Successive U.S. Presidents have placed seven men and women on the Board—at least six of them with your confirmation—and they have to work together to walk a tightrope. But seven become 19 participants when Board members meet with the presidents of the regional banks to determine monetary policy and to issue instructions to the trading desk of the New York Fed.

Each bank president brings an attendant economist to FOMC, who from time to time gets up to whisper in his boss's ear about how the Board projections and the Board staff projections and the 18 sets of comments by FOMC participants jibe with the regional economics.

Each of the 19 committee members articulates his or her varying outlook for the economy and a staffer from the New York Fed describes the money markets and the capital markets from that point of view.

So you have a discussion group in which in terms of participants is dominated by the bank presidents and the staff members who are sharing information at the time of the discussion of monetary policy.

So the final vote, again, will be known to the outside world 5 or 6 weeks later, when the report of policy action is released.

This is too long a delay. Of course, the Fed wants all the flexibility it can get. Holding the information up from the markets helps flexibility. Some of that is certainly warranted.

Now back to the bank presidents.

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You may think that a hawkish bank president, one repeatedly voting for tight money, is accountable to his or her board of directors, not to Congress. Technically, that's true. But bank presidents report their views here to Congress only occasionally, and the bank's directors receive their briefings from the bank president and his staff.

The Fed bank board meetings I've attended showed the strong leadership of the bank president in this matter. A visiting Fed chairman may have even more influence. I don't argue that monetary policy has to be politically correct, but there certainly is a resemblance here.

If I may respectfully urge, the committee members should be aware that the selection of Fed bank presidents is not merely a local endeavor by a bank's board of directors affirmed by the Washington board.

Technically, that is true.

But note the influence of the Fed chairman. Each successive chairman of the Fed has had his own strong orientation toward the importance of one of the Fed's objectives over the other objectives. And, of course, it changes over time.

My dealings with Arthur Burns when I was bank board chairman convinced me that he leaned toward achieving economic growth rather than disinflation when he felt economic conditions permitted a choice.

Volcker's fixation on reducing inflation was evident, serving with him, even at times when very slow growth or recession, as Professor Tobin has alluded, was the price the economy would pay. And we have had several years cited as examples.

I would add 1986 to the list.

Now a discussion of a 5 year Fed goal of zero inflation continues to take place. Zero inflation. Legislation to that effect is introduced in successive congresses and supported by the Fed. But think of the price the economy would pay in lost jobs and living standards and financial market dislocation, which could well result in the short run.

We live in the short run, as Keynes's is reported to have said, and our slow growth in the past few years is not an ideal level from which to seek zero or near zero inflation.

Now if a zero inflation chairman with a global reputation gets on a plane and confronts a Fed bank board of directors with his preferred candidate for a bank presidency, what do you think the chances of rival candidates are likely to be for that job? And if the chairman succeeds, aren't you likely to have a bank president who will have a great voting record favoring tighter money and higher interest rates?

You bet you will.

I have reviewed FOMC minutes summaries from May, 1982 through February, 1986 to ascertain the bank presidents' voting patterns during my tenure at the board. You will certainly recall that this was a period during which Paul Volcker's record as a fighter of inflation was not simply noted in the Washington Post editorials. It was real. Paul was and is a price stability champion. Policy during his tenure was particularly and specifically aimed at curbing inflation.

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Despite that leadership, bank presidents felt it necessary to dissent formally, not to mention their influence at meetings themselves, to dissent formally at FOMC meetings about 20 times in favor of even tighter money and even higher interest rates. Only four or five times did presidents dissent for faster growth in the monetary aggregates or lower interest rates.

These were tighter money dissents from Volcker's tight money policies.

Today's bank presidents' dissents go in the same direction. Today's bank presidents' dissents favoring more pressure on reserves or slower money growth or higher interest rates or all of these, have continued under Chairman Greenspan.

It would not serve any purpose here to personalize the hawks among the bank presidents.

The point is that these leaders, as conscientious and as qualified as they are, bring to the making of monetary policy a mindset which did and does affect national policy in one direction.

The public interest is best served by Federal Reserve policy making which results in progress toward several intermediate policy goals. Price stability number one, certainly. Price stability, sustainable economic growth, expansion of monetary aggregates, and the maintenance of conditions in the foreign exchange and domestic financial markets.

Overemphasis upon one goal will be at the expense of one or more others. Let me give an example.

Very high interest rates and strong pressures on bank reserves were deemed necessary by the Fed to curb high inflation, as has already been indicated, in 1979, 1980, and 1981. One price of reserve and monetary extreme tightness was the resultant mark-to-market insolvency of the whole savings and loan industry, with its huge portfolio of low, fixed rate residential mortgages.

They were sitting there with 5 percent mortgages, 6 percent mortgages on the books, and interest rates going to 10 and 12 and 13 and 14 percent.

So as they raised funds at the margin, of course, they were on a mark-to-market basis using those interest rates against their existing assets, insolvent.

Community banks trying to serve their community, the smaller banks with large portfolios of fixed-rate, low-rate mortgages were hit to a great degree, also.

Yes, the Fed achieved relative price stability, and it is greatly to their credit to have achieved it. But the stage was set for the thrift industry to seek higher rates on assets, capital gains on assets, and to go into fields which resulted in the losses for which we're so well familiar—high risk/reward assets. And we know the results.

A lesson, I submit, is that FOMC decision making should proceed toward multiple goals, including, but not overly emphasizing price stability.

Now to me as a board member, the bank presidents brought an invaluable reporting on regional economic health or the lack of it, from their staffs and from their very strong boards of directors of those banks. Bank presidents have very long tenures as a rule and many of them come to play their role following decades with the Fed bank or the Fed board bureaucracy.

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Mr. Chairman, I know we have discussed today the compensation of the bank presidents. I would only dissent from my distinguished colleague in this sense.

The bank presidents' activity and responsibility in running a huge private Government bank, in doing the clearings of checks and wire transfers, the clearings in our payment system, in playing the role of the lender of last resort, in advancing funds to their membership—all of the other activities of the bank require that you have technically competent, experienced bank presidents performing these functions.

I conclude that the proposal in S. 1611, to create an advisory council of the Fed bank presidents is absolutely necessary. You cannot lose the council and the information of these functionaries.

Nonvoting presidents will still make an important contribution to policy making. I join in the preceding comments to that regard. Discount rate recommendations should continue to originate in the Fed banks.

The unique responsibility of the New York Fed's president in implementing open market operations puts this official in a special category. He or she must be involved in setting goals and modifying them. Policy making participation and counsel are more important than the actual vote by "New York" on a goal setting direction.

In summary, Mr. Chairman, the making of monetary policy in today's computer linked, 24 hour, instant information, international financial world is too important, too risk/reward driven to be left to yesterday's institutional arrangements.

The political appointment and confirmation of those who most influence the quantities of monetary aggregates, the costs of credit, the values of the dollar internationally, and other aspects of our economic growth must be the responsibility of the President of the United States and the Congress.

Fed bank presidents have the vital function of bringing to Washington their regional considerations. Let the presidents speak out before the policy decisions are announced, but hold the chairman and his board colleagues responsible for the monetary decisions and their implementation.

Thank you, Mr. Chairman.

[The complete prepared statement of Preston Martin follows:]

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The Monetary Policy Reform Act of 1991
Testimony on S. 1611

by Preston Martin, Ph.D.

before the

Committee on Banking, Housing and Urban Affairs
U.S. Senate

November 13, 1991

Presently Chairman of the Board and CEO of WestFed Holdings, Inc., Marina del Rey, California; SoCal Holdings, Inc., Beverly Hills, California; and H.F. Holdings, Inc., Honolulu, Hawaii.

Formerly Vice Chairman, Board of Governors of the Federal Reserve Board; Chairman, Federal Home Loan Bank Board; and Savings and Loan Commissioner, State of California. Formerly Chairman and CEO, Seraco Corporation, Sears, Roebuck; and Chairman and CEO, PMI Mortgage Insurance Corporation.

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Mr. Chairman and members of the committee, I am here today to testify on S. 1611, the Monetary Policy Reform Act of 1991. To do so, I have reviewed my 49 months experience as a governor and vice chairman, and I reread summaries of the Federal Open Market Committee (FOMC) results at the Board of Governors (the Fed). I would also refer to the Federal Home Loan Bank Board (FHLBB), where I served four years as chairman.

The record of policy-making of the Fed over almost eight decades has been a most outstanding one. In the post-World War II period, I believe that only the Bundesbank in Germany can boast of such an outstanding record of fighting inflation and (sometimes contradictorily) fostering economic growth. For those two central banks, the independence of the entity from the U.S. Treasury or Federal Republic Ministry of Finance, I believe, has been a substantial advantage. Like any human institution the Fed has made its mistakes, but Fed board members themselves have a degree of personal security derived from fourteen-year terms and from

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Fed board member traditions of professionalism and integrity, traditions which often are lost in a media-oriented world today. The FOMC members have an outstanding record of voting their consciences, not the politics of the White House from which their appointments originated. The same behavior characterizes the Bundesbank members, all of whom are political appointees. I can recall informal conversations in Basel, Switzerland, with Karl Otto Pohl, then of the Bundesbank, regarding the performance at his meetings involving the officials of the Lander. I had the distinct impression that Karl Otto was quite content with the political appointees who represented the regions of his country. Certainly the record of the Bundesbank as champion of gradualism in price increases is notable.

Permit me to comment on the role of this committee in reviewing appointments to the Board itself. My background includes teaching financial institutions and monetary policy for 20 years

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or so, including the University of Southern California, and assignments in Turin, Italy and Karachi, Pakistan. My Ph.D. is in monetary economics. Thus I appreciate academic credentials for Board membership. However, my four years on the Fed Board convinces me that it is clearly in the public interest to confirm board members who have a variety of "real world" experience, experience in the business arena, the financial areas, and time spent as regulators: all are useful at the Board, even indispensable.

A diversity of geographic backgrounds is a second criterion. The U.S. has now endured the increased impact of regional business cycles which have been notable: first the middlewestern "Rust Belt," then the farm states' crisis, and then reversal of the "Massachusetts Miracle" all over New England. Today greater New York and its environs are suffering, and the growth rate in once booming California has yielded to normalcy, just ordinary growth!

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I respectfully recommend that this committee return to a criterion of the Federal Reserve Act which mandates geographic diversification of the Board Membership itself, not just among the Fed bank presidents.

Given the degree of success of the U.S. central bank, why reconstruct or reform the institution? Under Chairman Greenspan's chairmanship, a new collegial nature of the Board has been fostered. Both board members and Fed bank presidents have been heard from, both far more than was possible during Paul Volcker's regime during which I served. Bank presidents and board members have been speaking out on policy matters and upon the economic outlook. This is not an indication of undue divisiveness, in my experience. You know that economic forecasting itself and the timing, and even the impact of monetary policy are extremely difficult to forecast. Even the best projections of monetary policy's impacts must wait six months, nine months, sometimes

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longer to be realized. The globalization of financial and economic and markets and institutions further complicates finding cause and effect. Witness the erratic behavior of the monetary aggregates over time. Look at the changing shape of the yield curve within just one quarter, as short rates are driven down by market conditions and abetted by the Fed, while long rates stay steady or even climb in anticipation of inflation. Observe the number of Fed funds reductions versus the present "no growth" monetary aggregates in real terms.

Of course there are healthy differences of opinion within the FOMC on price stability and upon growth prospects. Media attention to the diversity of views among bank presidents and Board members is both a blessing and a curse. The blessing comes from attention to the disinflationary biases of many of the presidents, the so-called "hawks" in monetary policy matters. The "curse" is of

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course disturbing the thinking of the army of Fed watchers on Wall Street.

We pride ourselves on having a "government of laws, not of men" but monetary policy is made and carried out by a small group of individuals discussing and arguing in a massive Board room. Successive U.S. Presidents have placed seven men and women on the Board with your confirmation, and they have to work together to walk a tightrope. Seven become nineteen participants when board members formally meet with the presidents of the regional banks, five of them voting, to determine monetary policy at the Federal Open Market Committee,(the FOMC) and to issue instructions to the trading desk of the New York Fed Bank.

Each bank president brings an attendant economist to FOMC who, from time to time, gets up to whisper in his boss's ear about how the Board staff projections and the 18 sets of comments by FOMC participants jibe with regional news. Each committee member

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articulates his or her varying outlook for the economy. However, the final vote will only be known to the outside world say five weeks from then when the "Report of Policy Actions of the Federal Open Market Committee" is released. That is too long a delay. The Fed wants all the flexibility it can get, and holding up the information from the markets helps.

Ah, you say, but a hawkish bank president is accountable to his or her board of directors, not to Congress. Bank Presidents do report their views here to Congress occasionally. Yes, but the bank's directors receive their briefings on the economy from the bank president and his staff. My attendance at bank board meetings showed the strong leadership the bank president exerts. A visiting Fed chairman may have even more influence. (I don't argue that policy has to be "politically correct," but there is a resemblance.) Discount rate changes are first recommended by a bank's directors, under the president's leadership. The Fed Board can take it or leave it.

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Committee members should be aware that the selection of Fed bank presidents is not merely a local endeavor by a bank's board of directors, affirmed by the Washington board. Note the influence of the Fed chairman. Each successive chairman of the Fed has had his own strong orientation toward the importance of one of the Fed's objectives over other objectives. My dealings with Arthur Burns when I was FHLB Board Chairman convinced me that he leaned toward achieving economic growth rather than disinflation, when he felt economic conditions permitted a choice. Volcker's fixation on reducing inflation was evident, serving with him, even at times when very slow growth was the price the economy would pay. 1984 and 1986 are two examples.

Discussion of a five year Fed goal of zero inflation is nothing new. Legislation to that effect is introduced in successive Congresses and supported by the Fed. But think of the price the economy would pay in lost jobs and living standards from the bank reserve pressures and the higher long-term interest rates

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which could well result in the short run. We live in the short run, as Keynes is reported to have said, and our slow growth in the past few years is not an ideal level from which to seek zero or near zero inflation. Now if a zero inflation chairman with a global reputation gets on a plane and confronts a Fed bank board of directors with his preferred candidate for a bank presidency, what do you think the chances of rival candidates are likely to be? And if the chairman succeeds, aren't you likely to have a bank president who will have a great voting record favoring tighter money and higher interest rates?

I have reviewed FOMC minutes' summaries from May, 1982 through February 1986 to ascertain the bank presidents' voting patterns during my tenure. You will certainly recall that this was a period during which Paul Volcker's record as a fighter of inflation was not simply noted in Washington Post editorials. Paul was and is a price stability champion. Policy during his tenure was

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particularly and specifically aimed at curving inflation. Despite that leadership, bank presidents felt it necessary to dissent formally at FOMC meetings approximately 20 times in favor of even tighter money and/or even higher interest rates. Only about four times did president dissent for faster growth in the monetary aggregates and/or lower interest rates. (Other dissents were of a technical nature). These were tighter money dissents from Volcker's tight money policies! Bank president dissents favoring more pressure or reserves, or slower money growth, or higher interest rates, or all of these have continued under Chairman Greenspan. It would not serve any purpose to personalize the "hawks" among the bank presidents. The point is that these leaders, as conscientious as they were and are, bring to the making of monetary policy a mindset which did affect national policy in one direction.

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The public interest is best served by federal reserve policy making which results in progress toward several intermediate policy goals: price stability, sustainable economic growth, expansion of monetary aggregates, and the maintenance of conditions in the foreign exchange and domestic financial markets. Emphasis or overemphasis upon one goal will be at the expense of one or more others. Very high interest rates and strong pressures on bank reserves were deemed necessary by the Fed to curb high inflation in 1979, 1980, and 1981. One "price" of reserve and monetary extreme tightness was the resultant mark-to-market insolvency of the whole savings and loan industry, with its huge portfolio of low, fixed rate residential mortgages. Community Banks with similar portfolios were hit. Relative price stability was achieved. But the stage was set for the thrift industry to seek high balance sheet values from high yielding, capital-gain prone assets of the highest risk/reward ratios. You know the results.

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I argue that the U.S. "paid" a high price in financial market instability and taxpayer costs, all of which began with the very high market interest rates of the late 1970s and early 1980s. The thrifts sat there with 6% fixed rate mortgages on their books, paying much higher interest rates at the margin for their funds. Of course the "bailout" costs arose from subsequent policy efforts to counter or relieve thrift balance sheet insolvency. A lesson, I submit, is that FOMC decision making should proceed toward multiple goals including, but not overly emphasizing price stability. An FOMC with a membership having both real world and academic credentials and with geographical diversity has the best chance of success in this. Furthermore, members should not be predominantly alumni of the same of a similar bureaucracy.

To me as a board member, the bank presidents brought an invaluable reporting on regional economic health or lack thereof, from their staffs and from their unusually strong business and

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labor board members. Bank presidents have very long tenures as a rule, and many of them come to play their role following many successful years with a Fed bank or the Fed board bureaucracy. Their budgets are subject to Fed board review, but not Congresses'. In today's changing financial world, of course, a bureaucrat often has one year's experience over and over again. Federal Reserve bank presidents bring to the periodic meetings with the Board in Washington many years of operating experience in a special type of government/private banking. The role of regional Fed banks in clearing check and wire transfer transactions is a vital one. The examiner staffs work for the banks. Thus the proposal in S. 1611 to create an Advisory Council of the Fed bank presidents is absolutely necessary, in my experience. Nonvoting presidents will still make an important contribution to policy making, and discount rate recommendations should continue to originate at the banks. The unique responsibility of the New York Fed's President in

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implementing Open Market operations puts this official in a special category. He or she must be involved, together with one or more New York bank staff members in setting goals and modifying them. Policy making participation and counsel are more important than the actual vote by "New York" on a goal setting question.

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SUMMARY. The making of monetary policy in today's computer-linked, 24 hours instant informational international financial world is too important, too risk/reward driven to be left to yesterday's institutional arrangements. The political appointment and confirmation of those who most influence the quantities of monetary aggregates, the costs of credit, the values of the dollar, and even aspects of our economic growth must be the responsibility of the President and the Congress.Fed Bank presidents have the vital function of bringing to Washington their regional considerations and from time to tome, an economic scenario which can be an alternative to the Washington Board's projections. Let the presidents speak out before the policy decisions are announced, but hold the Chairman and his board colleagues responsible for the policy decisions and their implementation.

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Senator SARBANES. Thank you very much. In fact, we thank both of you for very strong statements.

I have a couple of questions, then I'll yield to Senator Sasser.

The National Journal is a reputable publication here that covers the activities in Washington. I want to read to you from their October 19 issue, and then I want your reaction to what they've written in their "Inside Washington" column.

Inflated fears about the Fed? Treasury bond holders beware. A little noticed bill could sap the value of your nesteggs. The bill would strip presidents of the Federal Reserve system's 12 district banks of their votes on monetary policy. Supporters say monetary policy maneuvers which are executed by means of Treasury bond transactions, should be set solely by the Fed's Board of Governors in Washington. But Wall Street bond dealers have little confidence in the ability of inside-the-beltway Fed leaders to fight inflation. And there are predictions that big investers will dump Treasuries by the truck load if the bill gathers steam.

End of article.

Now that's the kind of stuff we have to contend with. And I'd just like to get your comments about that.

Mr. MARTIN. I think that set of comments probably sold subscriptions to the National Review.

Senator SARBANES. National Journal, yes.

Mr. MARTIN. National Journal. But in terms of the realities, let's again remember how the Fed functions.

The interaction, the networking between the staffs of New York, Chicago, San Francisco, and so forth, and the staffs in Washington, are of course ongoing.

That magazine article assumes that a Fed bank president never goes to Washington and talks to Alan Greenspan, except 2 minutes before the FOMC. This is an organization that I am honored and delighted to have spent 49 months in. It is a network of networks. It functions—the exchange of information in the decision making is beautiful.

And for that magazine to assume that because the bank presidents don't vote, they wouldn't share information, they wouldn't participate in the process, I think borders on nonsense.

Senator SARBANES. Mr. Tobin?

Mr. TOBIN. I think the record of the Board of Governors and the Chairman of the Board of Governors over a long period of time would suggest that they don't deserve that statement at all.

They're not going to throw caution to the winds all of a sudden and inflate the economy just from some populist whim.

I believe that Alan Greenspan, Paul Volcker, Arthur Burns, Bill Martin, have tried pragmatically to reconcile the goals of growth, employment and price stability in a generally reasonable way, differing among themselves from time to time, to be sure, and not satisfying all of us on either side of those debates. But certainly not guilty, and would not be under this law, of doing what would rationally trigger any such reaction in the bond markets.

I think you're going to face the fact that any time you try to fiddle with monetary policy decision making and with the structure of the Federal Reserve, these scare tactics will be used.

But you really have to set up governmental institutions in ways that make sense and are faithful to the democratic principles of

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the country. You cannot let them be made in fear of what will happen to the bond markets.

Moreover when I hear statements like that I always want to ask about all these bonds that are going to be dumped. What are the people who are going to dump them going to do with their money when they're not investing them in bonds?

It's not so easy a thing, you see. Right now, I hear people say, well, if the Federal Reserve would lower short-term interest rates too much—even perhaps, some people said, lower them as much as they already have—that will cause portfolio managers to dump long-term Government bonds and make long-term rates rise.

But the main alternative that the investors in long-term bonds have is to put their money in shorter term securities, which are made less attractive by the very action which is supposed to have triggered this perverse response.

I don't think it's good economics and certainly not good political theory.

Senator SARBANES. The other question I want to put, and it's off on the side because it really deals with the substance rather than the process.

But I'm concerned that goals get into our economic discussion. They assume a sort of legitimacy, even though no one really expects you're going to reach that goal. But the whole discussion is affected by having it out there. And the goal I'm thinking about is zero inflation.

So here's what happens. Some member of the Congress throws in zero inflation. Then the Fed people come in and they say, well, they get asked about this. Well, they don't want to say that they're not for zero inflation because then they figure that that's going to send a signal to the country that they're not concerned about inflation.

Then they say, well, they think it's a goal toward which we should be working and which we should try to achieve.

So then, all of a sudden, it becomes a reference point in the economic discussions.

Now, what do you think of the goal of zero inflation? What other country has—I don't know any other country that has zero inflation, even countries that have very good inflation fighting records.

What would the cost of it be in terms of economic growth and the equities in the functioning of the economy? And should it really become a reference point in the economic discussion?

Could you all address that question? Then I'll yield to Senator Sasser.

Mr. MARTIN. I commented on my attitude. Perhaps I should defer to Jim.

Mr. TOBIN. Well, I think that there are two aspects. One is whether it's a good thing to move toward zero inflation right now, and second, whether it would be a good long-run objective to achieve zero inflation.

The history that we've been through these last 10 years is that we've stabilized the rate of inflation after the deep recession in the early part of the 1980's, once the economy was turned around by the Fed with inflation in the range of 4 or 5 percent.

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It remained at that rate throughout the 1980's, and even has declined a bit recently, the last couple of years. I think the country has been very satisfied with that record. Inflation has not tended to escalate into ever higher rates, into hyperinflation, and 4–5 percent has been accepted as if it were zero. That's just as good as if it were zero.

Therefore, I think it would be extremely gratuitous at this time, and mischief making, to say, now we want to finish the job and get inflation all the way down to zero. The consequence of that would be to condemn the economy for several years ahead to further stagnation and maybe another recession.

I think the public attitude toward the present doldrums of the economy indicates that such a crusade would not be a popular thing to do. It would have a lot of unfortunate implications for all kinds of policies, and all kinds of economic conditions, both those within Federal Government jurisdiction and those of State and local Governments.

So I think that would be a very bad and mischievous thing to do at this moment. It would be saying, we're not going to try to recover from this present situation. Instead, we're going to keep the economy slack and stagnant until we get inflation down to zero.

Although zero inflation sounds like an attractive idea from a long-run point of view, I'd point out that it does make the job of stabilizing the economy against shocks to demand and supply more difficult.

The reason is that you may need to get interest rates in a real sense—that is, interest rates subtracting off inflation, real interest rates—you may need to get them down close to or below zero at times. That may be the only way sometimes to get the economy moving and stimulate enough investment to employ the labor force.

It's very difficult to get real rates down close to zero if the inflation rate is zero because you can't ever get ordinary interest rates, nominal, preinflation interest rates—below zero.

You have more freedom to maneuver in monetary and fiscal policy for stabilizing the economy if you have 2 or 3 percent inflation, because then, if you get interest rates down close to zero, you've got very attractive real rates of interest.

That's perhaps a technical thing, but I think it is of some importance.

Senator SARBANES. It's an interesting point.

Mr. MARTIN. I think, too, Mr. Chairman, if I could comment, I think the zero inflation target or dictate to the Fed would fly in the face of our most basic economic problems at this time.

We are a low-saving, low-productivity, moving into more and more of our GNP used in services, high Federal deficit situation.

To force economic growth itself down to zero or negative in order to attain a zero inflation level at a time of our own adjustment within the most basic elements of our economy, I think would be disastrous public policy.

Senator SARBANES. Senator Sasser?

Senator SASSER. Thank you, Mr. Chairman. I couldn't agree more. I think it would be disastrous to try to go down to a zero in-

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flation rate. I'm not sure a zero inflation rate is ever economically healthy from the point of view of trying to get an economy to grow.

Mr. Martin, I was fascinated by your explanation of what occurred in the savings and loan industry beginning in 1979, 1980 and 1981, with the rapid run-up in interest rates and the savings and loans holding 5 and 6 and 7 percent mortgages at that time. Perhaps because it supports what I have thought and said independently on other occasions.

Do you characterize the interest rate problems or the rapid run-up in interest rates in the late 1970's and early 1980's, as the proximate cause or the precipitating cause of the collapse of the savings and loan industry?

Mr. MARTIN. No, Senator, I would not so characterize it. I certainly would bring out the point, however, that interest rate policy coming from the central bank needs to take into account the impact on financial conditions, financial markets, financial institutions.

Certainly, the very high interest rates of the late 1970's and early 1980's were helpful in curbing the inflation that was bedeviling the economy at that time.

The question is only to recognize what cost a particular set of policies have in the fullest sense, which is why again I would hope that there would be board members on the Fed in the future that had had regulatory background and had seen what happens when you have hyper interest rates, would have had some experience in different kinds of financial institutions, maybe including small community banks, insurance, thrift institutions, savings banks, so that when the FOMC decides to raise those interest rates, at least the consideration could be in the discussion of, OK, I vote along with the rest of you folks, but remember what the price is going to be. We're going to have some failures out there, or at least we're setting the stage for some failures.

If there are additional mistakes made, as there were in the early 1980's, the giving of investment and lending powers to the thrifts and then having inadequate supervision of them as they went into new kinds of assets and new kinds of loans—of course, it wasn't the high interest rates. It was the mistakes made under the Garn-St Germain Act by those thrift institutions and the weak supervision of them once the Act was on the books.

Senator SASSER. Well, Mr. Martin, I agree with you. And at the risk of—we Senators have a habit of talking too much and giving our own views rather than listening to the views of the experts that we invite up here to testify.

But I have long thought that the real culprit in the savings and loan industry debacle were the the high interest rate policies that were pursued in 1978, 1980 and 1981.

And, I well recall the S&L operators coming up here, honorable people, saying, we've got a portfolio full of 5-, 6-, 7-percent mortgages, as you indicated, and we're having to pay 12- and 14-percent on our money. We can't make it.

Then the next move was, we've got to get into other businesses. We've got to broaden our scope of operations, be more like a commercial bank. If we don't, we can't survive.

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In the era of deregulation, Garn-St Germain let them do exactly that. The fellow who could write a mortgage on a home in a subdivision suddenly found himself trying to deal in shopping centers 4 or 5 States away. They just didn't have the expertise for such negotiation.

I'm saying all this because the media in this country, and others, like to attribute the collapse of the savings and loan industry to a few unscrupulous operators working in concert with some politicians.

Nothing could be further from the truth. That's sloppy thinking. It's sloppy reporting. And it's sort of a sensational way of finding scapegoats.

But you've put your finger on the real issue this morning. It was the high interest rate policy, in my judgment, that drove them under. I think we're still paying the price for that.

In other words, we did shake inflation out of the economy in the late 1970's and early 1980's with a very high interest rate policy, which I think at the end even frightened Paul Volcker. I think even he was worried that the Fed had gone too far.

We shook inflation out, or a significant amount of it, but we're still paying the price for it in terms of the enormous deficits we're running now as we try to refinance the old FSLIC and the FDIC, et cetera.

So, there is a price to be paid by the taxpayers at large, many of whom had their lives ruined because their businesses went under.

So there you have it. Another Senator talking when he should be listening to the witnesses. I won't do that any more.

Professor Tobin, last year, the New York Times ran an article entitled, "It Isn't Just a Downturn; It's the bill for the 1980's."

The emphasis of the article was that the laissez-faire attitude of the 1980's had caused serious structural damage to this economy, that it could take years to repair the damage incurred during the 1980's. Problems including overbuilt and overpriced real estate, businesses consumed by worthless junk bonds, corporations struggling under the weight of debt incurred during takeover battles, and problems in the banking industry.

I wonder what your reaction would be to that. Do you consider that the excesses, if there were excesses, of the 1980's responsible or partly responsible for the decline in today's economy?

And, is this a severe structural problem that will take some time to recover from?

Mr. TOBIN. Senator, I don't think that the excesses that you cited of the 1980's necessarily doomed us to have the recession of 1990–91, or the slowdown that started in 1989.

I think there are serious problems and structural problems created by the fiscal policy and some of the deregulation policies followed in the 1980's. Those problems, most of them remain with us, even if we recover from the present recession or stagnation in the next year or so.

Senator SASSER. What are those problems, in your view?

Mr. TOBIN. Well, the long-run problem of the economy, which is going to be difficult for a long time, is the slowdown in the rate of growth of productivity of labor and the accompanying stagnation of real wages.

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I think the malaise that we see in the country right now about economic conditions is accentuated because two disappointments are imposed on each other.

One is the business cycle recession from which the recovery is not in sight yet, and which endangers people's jobs. The other is this long-run structural problem that will continue even when and if we get out of the current recession; namely, that recovery will not all of a sudden cause real wages to rise at the rate we were used to in earlier decades.

That's what's making people feel discontent with the course of the economy. A lot of the problem came from the fiscal policies, the exorbitantly deficit spending fiscal policies, that were followed in the 1980's. They reduced the rate of private and public investment in the country, and we had a consumption boom. It's private and public investment that lead to productivity growth and to real growth of per-capita income over the long run.

Senator SASSER. You stated, Professor Tobin, in your opening remarks that Fed bank presidents take a more conservative line than Fed governors on monetary policy, if I understood you correctly.

What is the reason for that? I think Mr. Martin laid out some of his views as to perhaps the reason for that, but what's your view as to why the Fed presidents take a more hawkish approach to monetary policy than the governors themselves do?

Mr. TOBIN. Well, I'm not sure. I'm not saying that this is an invariable rule, either. But I suspect it's their closeness to the financial communities in the districts where they come from.

Senator SASSER. Closeness to commercial banks, perhaps?

Mr. TOBIN. Not just commercial banks, but the general financial industries.

Senator SASSER. Well, I think Mr. Martin touched on how a chairman of the Fed could have influence over who would be selected as the president of one of the regional banks. The Chairman may have a tendency to select someone in his own image, so to speak, or may try to influence the board of the local bank to produce a president acceptable to the chairman.

But I return to the question of whether there is an innate tendency on the part of the presidents of the regional Feds to be conservative or hawkish with regard to monetary policy, regardless of what influence the chairman might have?

And I say that for this reason. Are they products, to some extent, of the commercial banks or the financial interest in their particular area. Would such institutions have an inclination to be opposed to any policy which might be viewed as even moderately inflationary?

Mr. MARTIN. Senator, my experience is the obverse of that. Put yourself in the place of a Federal Reserve bank president. You are 56-years-old. You've worked 25 years or 30 years of your life to get to be the president.

What kudo do you want to have on your record when you're no longer the president?

The kudo you want to have is I'm a real central banker, not one of those central bankers in Europe where the ministry of finance tells them what to do and they jump. I am a central banker and I voted and I've dissented to get inflation down.

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How do I make my reputation? By being an economic growth man? Not in that network. You make it by being harder than anybody. And boy, that Smith, when he was president of the San Francisco Fed, he really—your incentives are to be the toughest guy on the block. It had nothing to do with the banks in your area. The banks in your area would like to have the higher interest rates, right?

Senator SASSER. Yes.

Mr. MARTIN. They'd like to have more loans, more assets, more growth. That's not their orientation. You're making your reputation as the gunslinger.

Senator SASSER. So there are no kudos for those who favor economic growth.

Mr. MARTIN. Never heard from again.

Senator SASSER. Well, why is that? Why is that the culture?

Mr. MARTIN. That's what is a central banker, right?

Senator SASSER. That's just the culture of the central banker.

Mr. MARTIN. Did you notice, they all wear these dark suits and plain ties and have this dour expression on their faces?

Because they're afraid that somewhere, someone might be happy. [Laughter.]

Senator SASSER. Well, on that note, I'll yield to you, Senator Sarbanes.

Senator SARBANES. I think that's probably a good note on which to thank this panel for a very important and valuable——

Mr. TOBIN. Senator, may I make one remark?

Senator SARBANES. Sure.

Mr. TOBIN. My good friend, Preston Martin, here said that he would leave the making of discount rates, the initiative for changing discount rates in the district banks.

We've mostly agreed today, so I'd just like to express some reservation about that.

I think if we're going to centralize monetary policy in a Federal agency with all the decision makers having the legitimacy that comes from presidential appointment and Senate confirmation, that their jurisdiction should apply also to the discount rate. It's an anomaly that goes back to history that the discount rates are made by the individual regional banks. What should happen in modern conditions is that the discount rate is a part of monetary policy just like the decisions about open market operations. They both are decisions about market rates of interest and the money market. You want to have the discount rate consistent with open-market policy.

That's why I would just put them together and make them both a responsibility and privilege of whatever is the central decision making authority.

Senator SARBANES. Let me ask this question. I have the impression that the discussion in Europe of economic policy is conducted within a more reasoned or rational framework than in this country. That both in the press and in the public—a lot of times, in this country, you'll get people who will say one thing privately about what they think ought to be done, or make some criticism, but they won't say the same thing publicly.

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We had business people when Reagan was running the big deficits who absolutely deplored them privately, and wouldn't utter a peed publicly.

Senator SASSER. And always voted for him.

Senator SARBANES. Yes. I mean, they'd say, these policies are catastrophe, but they wouldn't elevate that into the public discussion of policy.

Now, first of all, is my impression about the level at which the economic discussion takes place in Europe correct? I may be wrong on that. And if it is correct, what's the reason for it?

Mr. MARTIN. I think it very much depends upon which country you're referring to.

Senator SARBANES. Yes, that's true.

Mr. MARTIN. I think, again, the Bundesbank, my contacts with Karl Otto Pohl and others at Basel when we would have the Bank for International Settlement meetings there, contacts with the Japanese central bankers was one thing, but the French, the Italians, other participants in Bal, at the BIS meetings would be a function of what the Ministry of Finance wanted.

There just isn't the attention to the central bank because it lacks independence in most countries. The criticism is of the ministry of finance and the prime minister and the political party running things because the central bank is just a part of the finance ministry.

Senator SARBANES. All right.

Senator SASSER. Could I ask something?

Senator SARBANES. Sure.

Senator SASSER. Two questions, the first for you, Mr. Martin.

If you were running the Federal Reserve today, as the chairman, and in many ways, I wish you were, what would you be doing to try to get our economy going? What more could the Fed be doing?

Mr. MARTIN. Well, I think the very recent actions of the Fed, the increased attention to the negative—in real terms—negative growth of the monetary aggregates, I think that the careful bringing down of interest rates—one of the things that this board does very well, this FOMC, for that matter, does very well is they don't make big jumps in the discount rate. They don't force the Fed funds rate down too quickly.

I think the recent policies have been very positive. But I just think that if we could, without upsetting the market—you have to do everything—you have to have the inevitability of gradualism because the markets are so sensitive to what the Fed does and says. But if you could very gradually bring economic growth into the goal setting and let the markets know—and sure, we're going to fight inflation, but we think economic growth has been too low in the last 3, 4, 5 years, and we're going to carefully go into policies that will further growth.

I think if we could indeed convince the markets this was the case, you might get a better climate for investment and might even reach the consumer.

Senator SARBANES. Do you think a Fed chairman could say that—that's a very reasoned, balanced view. You're saying, look, we've got to control inflation. We've got to do something on economic growth and everything. Can a Fed chairman say that with-

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out touching off a huge alarm or has it now been so conditioned that the only public utterances a Fed chairman can make are sort of against inflation, for making sure that inflation doesn't get out of hand—then the producer price index goes up 7/10THS of a point this morning. It went up 1/10TH and 2/10THS of a point the 2 previous months. But that will set off these alarm bells.

Or has the dialog gotten so formalistic that a Fed chairman can only sort of utter this kind of rote statement?

Mr. TOBIN. I think the Fed chairman can say that his objective is to restore full employment in this economy, and that that, in his view, in his agency's view, in the Fed's view, can be done without endangering the country with higher inflation.

He can say that.

Senator SARBANES. Well, would you get these kind of National Journal sort of demagoguery here if he did something like that?

Mr. TOBIN. You're going to invite some of that. But let's remember that Paul Volcker himself abandoned the monetary aggregates, which used to be the proximate goals of monetary policy, indeed especially during the period, 1979 to 1982, under Paul Volcker himself.

So when he essentially abandoned them and made clear that the Fed wasn't going to take them seriously any more, what happened? Everybody in the markets breathed sighs of relief that were almost audible. The change of policy in favor of recovery rather than further anti-inflation crusade was welcomed everywhere.

It wouldn't take much more of the present stagnation to make that true again.

Mr. MARTIN. I think the chairman could incorporate the economic growth, the economic recovery, as part of a general statement to you when he makes his report and over time, stress it more.

The chairman is so right. You have to be very careful how you do this. But look what the Germans did as they brought those Eastern provinces into the Federal Republic. The Bundesbank, of all things, both Schlesinger and Pohl each said, now, we're going to bring these folks in and, in effect, further growth in the greater Germany.

Yes, they've had a little more inflation than they had before, but it isn't out of hand. You've had a shift in the Bundesbank, in other words, as they incorporated these Eastern provinces.

Senator SASSER. Mr. Martin, it's widely reported, or widely believed, that in October 1990, Chairman Greenspan was ready to move into some easing of interest rates and that he was, in essence, blocked or outvoted, or his views were disputed by the bank presidents at the FMOC meeting.

And some think, I think most believe, a critical opportunity was lost at a time when the economy was obviously suffering or was on the verge of taking a dip. A critical opportunity to give it a boost was lost.

Are you aware of other times when the Fed has failed to act, due to discord among members of the Federal Open Market Committee?

Mr. MARTIN. No, I did not witness—I served under Paul Volcker.

Senator SASSER. Right.

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Mr. MARTIN. I did not witness the kind of overriding of policy under Chairman Volcker stemming from the bank presidents' dissents or, more likely, argumentation within the FOMC meetings, so I'm not aware of that.

Chairman Greenspan I think has been successful in setting this collegial atmosphere at the Fed and encouraging more discussion, not just from the bank presidents, but also from his fellow board members. While I was on one of the Federal Reserve's advisory committees, I was not on that committee on those days and I don't have information. I don't know.

Senator SASSER. Thank you. Professor Tobin, one final question.

I think this committee would be remiss if we let an economist of your distinction escape today without giving us some thoughts about where we are presently.

Historically, if memory serves me correctly, since maybe 1900, business downturns have averaged about 18 months, if I'm correct in that assessment.

This recession, or downturn, has now ripened and is about to reach the classic 18 month average. Where do you see the economy going now? Are we indeed headed for what some say is a double dip recession, or do you foresee some sort of upturn, and if so, how significant and when do you think it might come?

Mr. TOBIN. I don't have a forecasting model, Senator. I think that the economy is weak on the demand side. Whether it is an actual recession in the sense of negative rates of growth of real production or whether it's slightly positive, doesn't seem to me to be all that important.

Even if there is technically a recovery under way, it's not a fast enough recovery to make up the ground that's been lost, even under the more optimistic predictions of forecasters through 1992.

Actually, I think that one should regard the par for this economy as real growth of 2½ percent per year, something like that. Zero is not good performance. So we shouldn't be satisfied if we reverse the negative growth of the actual recession and have positive growth.

We've had now 10 quarters of growth that were below 2½ percent. They were below the amount that's necessary to keep up with the growth of the labor force and productivity.

In fact, nine of those quarters—until the one that just finished—were below 2 percent.

So, in a more meaningful sense, we've had a recession that's much longer than the technical one that you were talking about. It's been 2½ years, almost.

So there's plenty of room for expansion and plenty of room for the Fed to move to get an expansion going.

Mr. MARTIN. The thousands of graduates of our finest universities, with academic records that are notable, are wandering around trying to get some kind of part-time, temporary employment.

The human cost of this no-growth, negative monetary growth situation we find ourselves in is shocking.

Senator SASSER. Yes, I'm the father of one of those, Mr. Martin, that's just graduated in June.

[Laughter.]

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There's one other thing I wanted to ask. Professor Tobin, I have a chart that Senator Sarbanes is very familiar with.

In that chart, we depict the per-capita GNP growth of every administration since World War II. This administration in office now is the first to suffer through a negative per-capita GNP growth since World War II. This chart bears out your statement, we've had 10 quarters of very lackluster performance.

In fact, it would not be incorrect to say that this administration is enjoying, or is suffering through, the worst GNP per-capita growth of any administration since that of Herbert Hoover.

Mr. TOBIN. That's right, Senator. As a matter of fact, I made some calculations like that for fun on my personal computer, too. Then I saw a picture of you and your chart in the paper and I was pleased to have such good support.

Senator SASSER. Well, I'm pleased to have such distinguished agreement on my chart.

Thank you.

Senator SARBANES. Gentlemen, thank you very much. You've been a very good panel.

If the other panel would come forward: Mr. Hilty, the chief economist of Chrysler; Mr. Seiders, chief economist of the home builders; and Mark Bernstein.

Gentlemen, you've been very patient. We appreciate of that. Because of the vote and so forth, the hearing has gone later than we anticipated.

If you could summarize your statements, we'll include the full statement in the record. If you could summarize it, we'd be most appreciative.

Mr. Hilty, why don't we start with you. We'll go right across the panel.

STATEMENT OF DONALD HILTY, CHIEF ECONOMIST, CHRYSLER CORPORATION, HIGHLAND PARK, MI

Mr. HILTY. Senator Sarbanes, Senator Sasser, my testimony is a perspective from the auto industry. Maybe business economists are a unique breed. I can't get along without charts and graphs. My testimony is in the form of eight schedules. Maybe I could go through them briefly, please.

Senator SARBANES. Surely.

Mr. HILTY. On page 1, I set the stage that we're probably influenced by Messrs. Locke and Rousseau, Locke, who said the division of power/representative Government was the way to go. Rousseau, who believed the general will was the most favorable to the public interest. And the fact that we have a political compromise now between these two concepts.

We do, in the Fed, have a combination of central authority and regional representation. But I'd like to make the point that our conduct of monetary policy has evolved even further from these two concepts. We have this unique form of regional representation giving private individuals a substantial voice in public affairs.

One more schedule to help set the stage is on page 2. Some people suggest that regional representation does not seem as important now as during earlier times.

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In searching the literature, I found four reasons for regional representation.

One, to get regional information to the central authority. With fast communication now, most economic data are collected by either congressional or administrative agencies. Very few are gathered by the regional districts. Data gathering is not original with them. Gathering regional information is not so important now.

A second reason is to explain central policy back to the regions. This, also because of fast communication, probably isn't so needed.

A third reason is to share decision making. Most economists feel that we should have not have regional monetary policy, so this reason also doesn't seem so important now. The fourth reason for regional representation is to make the central authority accountable to the regions. This is probably already done through the nomination process and the confirmation of the Senate of Fed Board Members.

The rest of my presentation is to show that, as currently constituted, regional representation at the Open Market Committee has not been even accountable to the respective regions on important issues.

So I am underlining what Governor Martin has said. On page 3 of my submission, I'd like to set the stage for the auto industry. Here I have a chart on the long-term demand for cars and truck and what actually is happening. In 1990, sales of cars and trucks were falling below this long-term trend, even though the auto industry was making massive efforts to try to prop up sales. We had huge incentives. We had low price increases. We increased turnover at daily rental firms.

Our production schedules were down to 1982 levels. Auto dealers were having credit problems. We had critical suppliers who were in financial distress. And rating agencies by November were downgrading our firms.

We in the auto industry were trying to tell the story to everybody who would listen. We talked to members of Congress. We talked to Cabinet members. We went to the White House. We also talked to the Chairman of the Federal Reserve and to some Governors.

However, on page 4, I point out that in this climate, and especially because of the importance of the auto industry to the fourth district—the fourth district has the second largest auto employment in the United States—we were dismayed that the president of the fourth district continued to push for tight credit. So he was not even representing his district.

The district has an economist roundtable that has a long and distinguished reputation there. They seek the views of banking and business interests in the region. In the past, the fourth district has based its recommendations to the open market committee largely on the views gathered at this economist roundtable.

We all were telling the president of the fourth district that business conditions were deteriorating quite rapidly. Yet, the public record showed that he was voting for tighter monetary policy. Anecdotal evidence was suggesting that he was very vocal in this debate.

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We looked for ways to try to encourage the president to support his district. Each of the auto chief economists were talking to him personally. We discussed whether we should go jointly to him and try to dramatize the fact that the auto industry was in bad straits.

We felt that this was probably a worthless endeavor. We found out that presidents were not responsible to the board of directors in the districts. In fact, we got evidence from some former Governors of the Federal Reserve Board that chairman of district boards were asking: "How do we get our presidents to represent us?"

So this is an example of the wild card that we have in the open market committee and is the main point of my testimony. It underlines what Mr. Martin said.

I'll go a little bit further on page 5 to show that the auto industry has not yet recovered. In fact, since November last year, the auto industry sales performance has been lower than what we would expect in the trough of a normal recession. We did touch the trough in June, but now auto sales have stalled and are deteriorating again. I believe this aborted recovery might have been avoided if monetary policy had not been so tight late last year.

Page 6, I show that the auto industry recovery now is the slowest recovery we've had since World War II, if indeed, we do have a recovery.

Now I'll go to page 7. The auto industry is continuing to cut production. These are showing up in the indicators that policy makers in Washington look at, and all economists are looking at. We are seeing fewer orders for durable goods, less industrial production, shorter work week, higher unemployment claims, less disposable income, negative impact on consumer attitudes and fewer retail sales.

We think cutting production in the auto industry is one of the main reasons this is happening. The auto industry does have a large multiplier throughout the economy.

So I finish up by saying that we wonder if we can afford the luxury of having private citizens, not subject to public review, making public policy. And we suggest, probably not. And the economy may have suffered because of the intransigence of some of these individuals. I hope these comments will help.

Senator SARBANES. They're very helpful. Thank you very much, Mr. Hilty.

Mr. Seiders?

[The complete prepared statement of Donald Hilty follows:]

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S. 1611, The Monetary Policy Reform Act of 1991

A Perspective From The Auto Industry

Testimony Before
The Committee On Banking, Housing, and Urban Affairs
United States Senate

November 13, 1991

Donald P. Hilty
Corporate Economist
Chrysler Corporation

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- **This Committee is evaluating the status of the Open Market Committee.**

Development Of The Federal Open Market Committee

Major Influences

- Political Philosophy
  - Locke: Division of power/representative government.
  - Rousseau: The general will is the most favorable to the public interest.
- Political Compromises
  - Combination of central authority and regional representation.

- Our conduct of monetary policy has evolved into a unique form of regional representation, i.e., giving private individuals a substantial voice in public affairs.

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- **Reasons for regional representation do not seem as important now as during earlier times.**

Reasons For Regional Representation

- Report regional information to central authority
- Explain and spread information from central authority to region
- Share decision making (Regional monetary policy)
- Make central authority accountable to regions

- The cyclical pattern of interest rates is one important factor that produces wide swings in the auto industry.
- The remaining pages show recent auto industry performance in this context.

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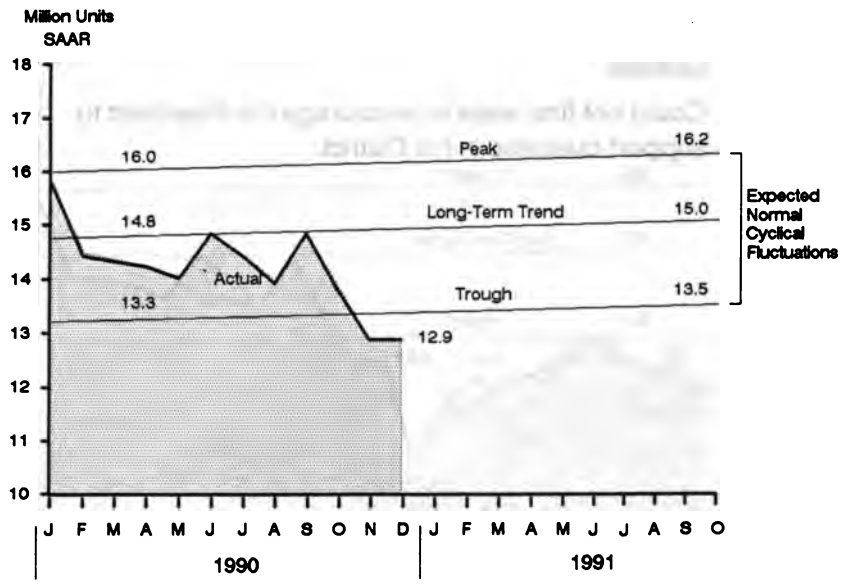
- **By November 1991, U.S. auto industry sales had dropped to a level worse than we would expect in a normal recession.**

U.S. Auto Industry



- Even these sales levels were being artificially supported with large incentives and extraordinary deliveries to daily rental firms.
- Production schedules were down near 1982 levels.
- Auto dealers were having credit problems.
- Many critical auto component suppliers were in financial distress.
- Rating agencies were downgrading auto firms.

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- **In this climate, and especially because of the importance of the auto industry to his district, we were dismayed that the President of the Fourth District continued to push for tight credit.**

- Regular Economist Roundtable briefings seemed useless.
- Could not find ways to encourage the President to support business in his District.

- This evidence emphasizes that regional members of the Open Market Committee are private citizens who can wield "non-representative" policy-making authority.

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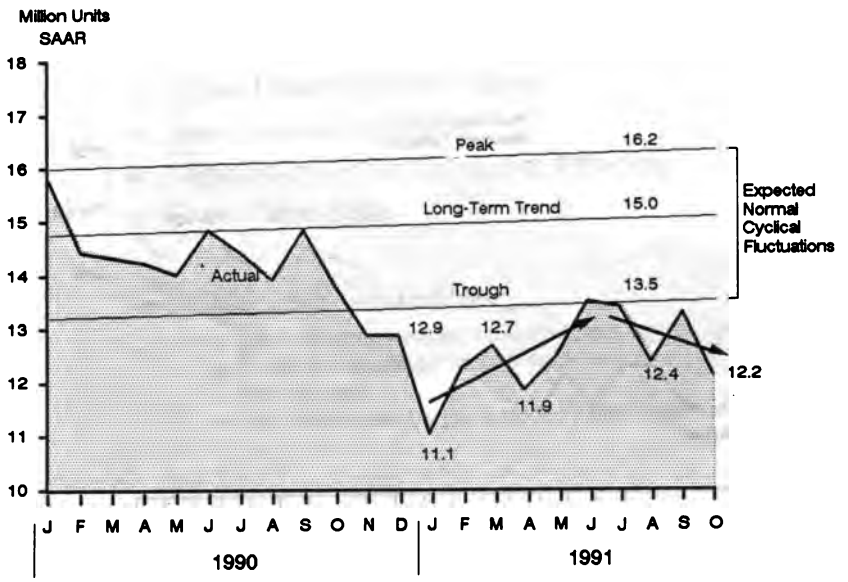
- **In fact the auto industry recovery did not rise above normal recession levels; more recently it stalled and now sales are falling again.**

U.S. Auto Industry



- Could this aborted recovery have been avoided if monetary policy had not been so tight late last year?

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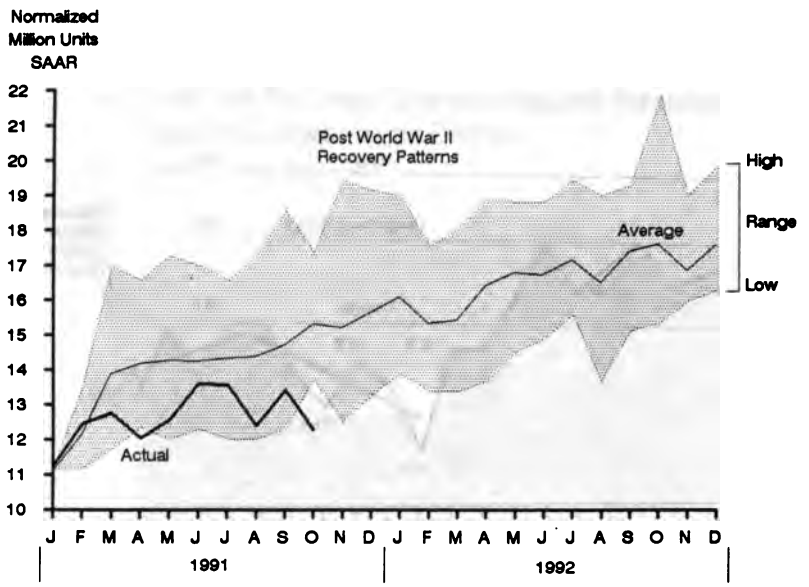
- **If, indeed, an auto industry recovery is underway, it is now the slowest recovery in the post World War II period.**

U.S. Auto Industry



- Based on the persistence of weak industry sales, most auto manufacturers are lowering their forecasts.
- Not being able to hold our industry forecasts means cuts in production, profits, and cash.
- Rating agencies take a short-term view. Will further downgrades make it even more difficult for domestic manufacturers to survive the recession and remain positioned for the recovery?

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- **What these production cuts mean to the U.S. economy**

- Fewer Orders for Durable Goods
- Less Industrial Production
- A Shorter Work Week
- Higher Unemployment Claims
- Less Disposable Income
- Negative Impact on Consumer Attitudes
- Fewer Retail Sales

Memo: Auto Industry Jobs Multiplier

- 1 auto assembly job generates 2 auto supplier jobs.
- These 3 auto jobs generate 5 ripple jobs in rest of the economy.
- So, 1 auto assembly job supports 7 other jobs.

- Because the auto industry has such a large multiplier effect throughout the economy, the low level of industry sales and production cuts will be felt by the nation.
  - The much-watched economic indicators will reflect this lower level of auto industry activity.

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Conclusions

- Can the U.S. afford the unique luxury of having private citizens, not subject to public review, making public policy? Probably not.
- The economy may have suffered because of the intransigence of some of these individuals.

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STATEMENT OF DAVID SEIDERS, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOMEBUILDERS, WASHINGTON, DC

Mr. SEIDERS. Let me try to summarize my statement quickly.

Senator SARBANES. If you would, please, sir.

Mr. SEIDERS. A quick reminder that the housing sector is the most sensitive part of the economy to changes in monetary policy. It always has been. It still is.

The housing sector has undergone a major contraction in recent years. In fact, I'm currently estimating that the total level of housing activity for 1991 will be the lowest since 1945.

Senator SARBANES. Did you see Mr. Hilty's charts? Did you see his statement?

Mr. SEIDERS. Yes, sir.

Senator SARBANES. So if you had done charts like that for the housing industry——

Mr. SEIDERS. I have some dandies for you.

Senator SARBANES. You do? OK.

Mr. SEIDERS. Yes, this has been a major housing contraction, even though the overall economic recession is still described as relatively mild. The housing downswing has been a major one.

Senator SARBANES. It's also called short, but it's now within a couple of months of being the longest recession in the post-World War II period.

Mr. SEIDERS. That's right. And I have installed a negative number for the fourth quarter in our own GNP forecast. So if we view the third quarter as a blip within the recession, we now have a rather long one.

That's correct.

Senator SARBANES. Yes. Sorry, go ahead.

Mr. SEIDERS. The housing depression certainly has been caused by a number of factors, including a couple of special factors this time through. One is what we call the regulatory credit crunch, which the National Association of Homebuilders has been talking to Congress about a lot. Another is the major swings in the tax code during the 1980's that combined to help drop the multifamily component to the lowest level on record. Management of monetary policy is another factor that we are quite concerned about. And when I analyze Fed policy during 1990 and 1991, there certainly are periods where Fed policy basically went on hold in terms of the Federal funds rate and the discount rate while the economy was still weakening, which really does amount to a *de facto* tightening of policy.

It was during these periods that we were hearing reports of factional splits within the FOMC, and a lot of talk about overly inflation hawkish Federal Reserve Bank presidents that were holding some sway. So that has been a key concern for the membership of the National Association of Home Builders and for me.

It is perfectly clear that we don't want voting members of the Federal Open Market Committee to be private citizens that are controlled by special interests such as commercial banks, and that have no accountability to the American people. So, in that sense, I agree fully with the ultimate objectives of S. 1611.

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The question in my mind is does Congress need to make what I would view as these major changes to the structure of the system in order to achieve its ultimate objectives?

Several people here today have referred to the changes proposed in the bill as minor. I think that the financial markets would certainly view them as major. I think we need to be sure about this before acting. I know you were not terribly impressed with the quote you were reading from the National Journal, but I think it was relevant.

In my discussions with people on Wall Street and the financial markets, and just watching how the bond market functions these days, one thing is for sure. The bond market is never going to forget the late 1970's and early 1980's, when inflation was allowed to get out of hand, when interest rates subsequently rose very, very rapidly and destroyed the value of bond portfolios.

So we do now have a hyper sensitive situation where some fear of increasing inflation gets transmitted quickly into the bond market. That's of great concern to the housing industry because we are heavily dependent on what happens to long-term interest rates.

There was some discussion that broke out earlier about real versus nominal rates and so forth. But the way that people finance their house purchases, it's nominal rates that matter.

So if, in fact, the bond markets should react to this kind of legislation and that the inflation expectation should rise, I think we would see an increase in long-term mortgage rates that would adversely affect the housing market. And I think there's a couple of reasons for that. One is that it's perfectly clear in the financial market literature I read that one of the objectives of this legislative effort is to get people who are strictly inflation hawks off of the FOMC. I think that perception, on its own, would provoke a reaction in the bond market.

Another is that, in recent years, the average tenure of Federal Reserve Board members seems clearly to have shortened. I was on the Fed staff until about 7 years ago and there's no member of the board there now that was there when I was there.

Senator SARBANES. If I could just interject there. I think you're quite right. I have deplored that development. And I think what is happening is that people are using membership on the Federal Reserve Board as a stepping stone to earning large amounts of money in the private sector. Point number one.

Point number two. The standard has deteriorated to the point that the only nominee to the Federal Reserve Board to whom a lot of attention is paid with respect to their ability and their qualifications and so forth is the Chairman.

Now it used to be that just to be a member of the Federal Reserve Board was a very significant achievement and people went on. They were held to a high standard. They served their 14 year term. Some served a second 14 year term. And they were regarded as sort of wise persons in the field of monetary policy.

Now you're getting people, they go on for 3 or 4 years and then they get off and they say, well, I've got to go make a lot of money out here in the private sector.

We get nominees that are not the best in the business. The Chairman there's still a lot of focus on. I think if you've got a

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chairman about whom there was this question, then there would be a lot of press attention and all. But it doesn't extend to the other six members of the Board, at least as I perceive it. It's just a dropping of the standard.

Mr. SEIDERS. That's right. And I think that its perceived as such. And therefore, it's felt that an incumbent administration can have a good opportunity to pack the Board with the kind of people they may want.

That is not something that plays well in the financial markets. That's one of my concerns.

So if the Federal Reserve Bank presidents are taken off of the FOMC as voting members, I think that, in combination with what's happened to the Board itself in recent years, is something that needs to be thought very hard about.

So I wonder if, in this environment, if what I view as a big change in structure as proposed in S. 1611, really is fully needed.

There are some things that certainly could be done short of that to help the system function properly. One is simply for the administration and Congress to quickly fill vacancies on the Board itself and, obviously, to try to fill them with quality people. The Board has been limping along with five people out of seven now for some time.

This may sound not very important, but Congress could also establish a statutory requirement that the chairman and vice chairman of the FOMC be the Chairman and Vice Chairman of the Federal Reserve Board.

Now, by tradition, the Federal Reserve Board Chairman is elected to be chairman of the FOMC and the president of the New York Fed is elected to be vice chairman of the FOMC.

If there was concern in Congress to be sure that the Federal Reserve Board, itself, had ongoing greater control over the policy situation, perhaps that change could be made.

I also thought that Professor Tobin, as I heard him, had a good suggestion. Rather than yanking them off the FOMC, Congress could have a hand in the selection, or at least in the approval of appointments to the district bank presidencies.

As you ran through earlier with your chart, and as I go through in my written statement, there clearly do seem to be a set of, in a sense, checks and balances within the current process by which the district bank boards are selected and then by which the bank presidents are selected and then approved by the Federal Reserve Board itself.

I'm sure you've been talking about whether or not this whole thing amounts to planned delegation of congressional authority through the Federal Reserve Board, or whether Congress is truly turning over some of the reins to people who have no accountability.

I think you can read the current arrangement as the Federal Reserve Board, which is appointed by the President and approved by the Senate, as having the responsibility—and not the way that Preston Martin ran through it, either. The rules and regulations are set up to govern the way that the bank boards at the district level are elected and then the way that the president is selected and then approved by the Federal Reserve Board.

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Maybe if that process worked right, it might be closer to what we need.

One further final possibility, and I say this a bit tongue in cheek, perhaps, but maybe one reason we get a lot of turnover on the Federal Reserve Board is that the pay is too low. I know in some specific instances that this was the case.

Whether we could have kept Press Martin around with higher pay, I don't know. But the turnover, rapid turnover on the Board, is something that troubles me rather deeply.

I think that basically summarizes my statement. It may sound a little bit schizophrenic. I am concerned about the way that the open market committee seems to have operated, at least in the few instances during the last 2 years. I think that the implications for the housing industry may not have been good.

But I also have concerns about a major change to the structure of the Fed, that could affect financial markets adversely and then feed back heavily and adversely on the housing sector of the economy.

Thank you.

Senator SARBANES. All right. Thank you very much.

Mr. Bernstein?

[The complete prepared statement of David Seiders follows:]

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STATEMENT

of

DAVID F. SEIDERS

before the

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

on

THE MONETARY POLICY REFORM ACT OF 1991

November 13, 1991

Introduction

Mr. Chairman, my name is David F. Seiders, and I am Chief Economist and Senior Staff Vice President for Mortgage Finance and Housing Policy at the National Association of Home Builders (NAHB). Prior to joining NAHB in 1984, I was a Senior Economist on the staff of the Federal Reserve Board in Washington.

I am pleased to comment on S.1611, the Monetary Policy Reform Act of 1991. This legislation would dissolve the Federal Open Market Committee of the Federal Reserve System, leave the formulation of monetary policy to the seven members of the Board of Governors of the Federal Reserve System, and create a new Federal Open Market Advisory Committee composed of the presidents of the twelve Federal Reserve District Banks.

I understand that the goal of this legislation is to ensure that the individuals who make decisions on monetary policy are accountable to the American people. To achieve this goal, S.1611

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would limit monetary policy decisions to Federal Reserve Board members who are appointed by the President and confirmed by the Senate, and remove from the decision-making process presidents of Federal Reserve District Banks who are neither appointed by the President nor approved by the Congress.

I also understand that this legislative effort has been stimulated by some well-publicized reports of splits among members of the Federal Open Market Committee during 1990 and 1991. These splits reportedly involved hard-line, anti-inflation positions by some of the Reserve Bank presidents at times when Chairman Greenspan and a majority of the Federal Reserve Board were in favor of easing monetary policy to stimulate economic activity.

This hearing comes at a critical time for the housing industry. Housing activity has contracted dramatically in the past few years, and I estimate that housing starts for 1991 will be at the lowest level since 1945. There are a number of reasons for this dramatic decline, including a regulatory credit crunch and prior swings in the federal tax code. But management of monetary policy has also been a factor. In retrospect, it seems clear that the Federal Reserve should have been easing monetary policy during 1990, rather than holding both the discount rate and the federal funds rate constant until very late in the year. I understand that the Persian Gulf crisis tied the Fed's hands last fall, but policy should have been eased earlier in 1990. The holding pattern evident during the middle months of this year also seems to have been ill-advised, since we now know that the budding housing and

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economic recovery is faltering.

The formulation of monetary policy clearly is a difficult art, and there are competing policy objectives that need to be considered. I share the Committee's concern about FOMC members who may want to aggressively pursue low inflation targets at the expense of reasonable targets for economic growth and employment, and zero inflation targets certainly are not in the best interests of the housing sector of the economy. Thus, I applaud the Committee's focus on the structure of the Federal Reserve's policy-making committee

Housing and Monetary Policy

The conduct of monetary policy is of critical importance to the housing sector of the economy. Housing has always been the most interest-sensitive sector of our economy. Prior to the late 1970s, a system of fixed deposit rates at thrift institutions and commercial banks provoked disintermediation and severe mortgage credit availability problems at times of high interest rates. In today's world, interest rate changes have strong impacts on housing demand because rate changes heavily affect monthly payments on long-term mortgage contracts used to finance home purchases in this country. In today's rate environment, a one-percentage-point shift in market interest rates will change the monthly payment on a 30-year, $100,000 home mortgage by about $75, altering the affordability of home purchase for thousands of Americans. Furthermore, many American home owners now have adjustable-rate mortgage contracts that make them vulnerable to market rate shifts.

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Although such mortgages generally have rate-adjustment periods of one year, the impacts of rate adjustments on monthly payments are large because the loans generally have 30-year amortization periods.

The "credit crunch" of 1990-91 has made monetary policy decisions even more important to the credit-dependent housing sector because of the unprecedented credit availability problems that have been created for the producers of housing. The credit crunch has been provoked by new capital standards at thrifts and banks as well as by overzealous regulators that have unnecessarily penalized institutions that make housing production loans. At the same time, dramatic shrinkage of the nation's system of depository institutions has made it difficult for the Federal Reserve to maintain growth of key measures of the money supply within the target ranges presented to Congress last July.

In this environment, even more aggressive easing of monetary policy is in order, and the Federal Reserve now seems to have adopted an aggressive stance to help stimulate economic activity. As discussed above, however, the management of monetary policy at several points during 1990-1991 apparently was not properly balanced.

Accountability of Policy Makers

Because of the extraordinary dependence of both producers and consumers of housing on readily available and affordable credit, the National Association of Home Builders traditionally has had an

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intense interest in the management of monetary policy. Furthermore, some of our members have long suspected that the banking industry exerts too much influence over monetary policy decisions, to the detriment of home builders, home buyers and home owners. Traditional linkages between the bank prime rate and floating rates on outstanding construction and development loans have fueled this concern.

NAHB's concerns in this area have been heightened by the highly publicized reports of hard-line, anti-inflation positions taken by some Federal Reserve Bank presidents serving as voting members of the Federal Open Market Committee in recent years. Indeed, the voting record for the FOMC in recent years shows that the Reserve Bank presidents, as a group, generally have been favoring tighter monetary policy than Chairman Greenspan and the members of the Federal Reserve Board, as a group. This record certainly provokes the question that the sponsors of S.1611 have been raising: Are the Reserve Bank presidents accountable only to their own boards of directors which are dominated by commercial banks in their districts? This issue definitely needs to be addressed.

Congressional Options

Direct involvement in monetary policy decisions by private parties that have financial stakes in such decisions, and that are not accountable to the American people, is wholly unacceptable in this country; thus, I fully endorse the objectives of the

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legislation you have proposed. I urge the Congress, however, to be extremely cautious when dealing with the structure of the Federal Reserve System. Financial market participants realize that the legislative effort discussed here today reflects frustration with some Reserve Bank presidents that have been preoccupied with fighting inflation. Thus, there is a danger that enactment of this legislation would raise inflation expectations and put upward pressure on long-term interest rates. Congress should also recognize that financial market participants may be concerned about the potential for greater control over monetary policy decisions by Congress and the Administration if Reserve Bank presidents are excluded from the FOMC -- a concern that also could exacerbate inflationary expectations. In recent years, there has been relatively rapid turnover of the Federal Reserve Board despite the staggered 14-year terms that were established to guard against this problem. Indeed, none of the current members were on the Federal Reserve Board when I left the Board's staff at the end of 1984.

It may be possible to achieve the objectives of S.1611, and avoid financial market disruptions, without making the major changes to the Federal Reserve System that are contained in this bill. Under the current structure, of course, there are rules and procedures that establish some lines of accountability for Reserve Bank presidents and limit the danger of commercial bank involvement in monetary policy decisions. These include the following: (1) only the 3 Class A directors of a Reserve Bank's board may represent member banks; (2) the 3 Class B directors must represent

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the public; (3) the Board of Governors appoints the three Class C directors of each Federal Reserve Bank, and the Board of Governors designates one of these as chairman and another as deputy chairman of the Bank's board; (4) no Class B or Class C director may be an officer, director or employee of a commercial bank, nor may Class C directors be stockholders of a bank; (5) the Board of Governors exercises final approval over the persons recommended by a Reserve Bank's board for the positions of president and first vice president, and the Board of Governors approves the salaries recommended by the Reserve Bank's board; (6) Reserve Bank presidents have 5-year terms, all but the president of the New York Bank have rotating 1-year terms on the FOMC, and the Federal Reserve Board is authorized by statute to remove any officer or director of the Banks.

Thus, the Federal Reserve Board, which is appointed by the President and approved by the Senate, can play a major role in the process of appointing and compensating Reserve Bank presidents, and rules governing the structure of the Reserve Banks' boards of directors should effectively limit commercial bank influence over the Reserve Bank presidents. Perhaps the Federal Reserve Board should be encouraged to give higher priority to assuring that the Reserve Bank presidents that it approves do not pay attention to only one of the set of policy objectives traditionally pursued by the Federal Reserve.

If the Congress wishes to further ensure that the Board of Governors retains a dominant position in monetary policy decisions,

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several steps smaller then those contained in S.1611 could be taken: (1) Congress and the Administration could establish a more timely process for filling vacant positions on the Board, (2) Congress could establish a statutory requirement that the Chairman and Vice Chairman of the Board serve as Chairman and Vice Chairman, respectively, of the Federal Open Market Committee. Currently, statute allows the FOMC to determine its own organization, and by tradition the FOMC has elected the Board Chairman to be its Chairman and the president of the Federal Reserve Bank of New York to be its Vice Chairman.

Thank you for the opportunity to comment on the important issues addressed by S.1611. I would be happy to answer any questions you may have.

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STATEMENT OF MARK BERNSTEIN, ATTORNEY, MORGAN, LEWIS & BOCKIUS, PHILADELPHIA, PA

Mr. BERNSTEIN. Yes, thank you, Senator.

Senator SARBANES. If you summarize, we'll include the full statement.

You did this note, didn't you, in the University of Virginia Law Review? Is that correct?

Mr. BERNSTEIN. I did.

Senator SARBANES. We have that. It's a very good legal exposition of this question.

Please go ahead.

Mr. BERNSTEIN. Thank you. I hope I can approach the problem from a different perspective than you've had so far today.

Senator SARBANES. Good. Right. Why don't you pull that microphone a little closer to you?

Mr. BERNSTEIN. OK. The subject of my note was the examination of the Federal Open Market Committee and the constitutional problems of the delegation of governmental power to private citizens, the reserve bank members of the committee.

I think that the arrangement does violate article 2 of the Constitution, which requires that the President nominate with the advice and consent of the Senate all superior officers of the United States.

It also entrusts the central tool of monetary policy to people who are not accountable either to Congress or to the President. Private interests certainly should be heard in the making of public policy, but to allow those interests to actually make public policy, particularly in an area as politically sensitive as the determination of the money supply, is, I think, to abdicate public responsibility.

Senator SARBANES. And of course, as Mr. Hilty points out, you've got private interests not listening to other private interests, which is of course one of the things public officials have to do, is to listen to all private interests in the course of reaching a policy decision.

But they have, I take it, a situation where they have felt that they really couldn't communicate their problems effectively to the president of the district bank for the district in which a large part of the industry is located.

Mr. BERNSTEIN. I think that shows that the idea of independence for the Federal Reserve is a good thing, but independence can be taken too far. This is an example with the private members, particularly.

The FOMC, as it's currently organized, affronts both the nondelegation doctrine and the separation of powers. The nondelegation doctrine states that Congress can't delegate its legislative or lawmaking responsibilities without setting definite standards for the delegates to guide and control their operations.

It probably is not possible to give precise directions to a board like the FOMC, which does have to respond to changing conditions.

But the separation of powers concern does arise and says that there should at least be some public oversight as to who is going to exercise that power, either in the appointment or the removal process.

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As it turns out now, the reserve bank members are not nominated by anybody with public accountability. They're nominated by the reserve banks. They're not removable.

It's a question of some debate whether or not they are removable even for cause as the members of the Board of Governors are.

So you do have a situation in which these people are unaccountable pretty much to anybody. And that raises some problems.

The chief problem that it raises, I think, is that it shelters Congress as well from accountability for its actions. Open market trading isn't intrinsically a function of Government. For a large part of the Nation's history, it's been left to private hands.

But having decided to make open market trading a governmental function, it's important that those who exercise this power be in some way accountable to the public.

I think it's probably true that the reserve bank representatives bring a unique expertise and perhaps a familiarity with regional banking concerns that would not otherwise be heard. But theirs isn't the only interest that could be represented on the FOMC, although theirs is the only interest which currently is.

Open market trading, is, I think, intrinsically a political act. There's no real way of determining what monetary policies ought to be without regard to the goals that you want to reach. Those goals affect the economy broadly and everyone in it. I think that goes to point out the reason why there needs to be at some level, sheltered from perhaps overt partisan pressures put on them, there needs to be some way of making sure that people who are going to exercise this very important power have some accountability at some level to the public, through Congress or the President.

I think the act, as it has been proposed, would be a very good compromise. You would allow the reserve bank representatives to have a voice, but not a formal vote. You wouldn't deprive the Board of Governors of their influence, but you would make sure that the Board of Governors, which is in fact accountable to the public, would have the final say.

And I would recommend that the bill be reported favorably.

[The complete prepared statement of Mark F. Bernstein follows;]

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STATEMENT OF MARK F. BERNSTEIN
BEFORE THE SENATE BANKING COMMITTEE
ON THE MONETARY POLICY REFORM ACT OF 1991

November 13, 1991

Members of the Senate Banking Committee:

I would first like to thank the Committee for the honor of inviting me to appear before you. The composition of the Federal Open Market Committee (FOMC) is rarely debated, although it deserves attention. My interest in this matter comes from a Note I wrote for the Virginia Law Review while in law school, which I have submitted for the record. I am now an attorney with the firm of Morgan, Lewis & Bockius in Philadelphia.

As Senator Riegle in particular is aware, although several challenges have been made to the constitutionality of the FOMC, they have met with little success. This is all the more reason why the Committee should be commended for addressing this issue in legislation. S. 1611, the Monetary Policy Reform Act of 1991, would repair the constitutional flaws in the FOMC as it is now organized, and I urge the Committee to report it favorably.

The FOMC is an example of legislative delegation unique in our government. Representatives of a regulated group, the regional Federal Reserve Banks, are given not only a voice, but a vote in setting monetary policy equal to that of the members of the Federal Reserve. These private representatives are selected by private bankers and are neither appointed by nor removable by the president. I know of no other example in which public policy

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is made by private actors who are not approved by the public and not accountable to them.

Such an arrangement violates Article II of the Constitution which requires that the president nominate, with the advice and consent of the Senate, all superior officers of the United States. It also entrusts the central tool of monetary policy to private hands without direction from Congress. Private interests should be heard in the making of public policy, but to allow those representatives to make public policy, particularly in an area so politically sensitive as the determination of the money supply, is to abdicate public accountability.

First, some history. The FOMC in its currently form was born of a compromise between a tradition of private bank independence and pressure for public control. There is nothing remarkable in that; most legislation can claim expedience as a parent. But the facts of this compromise show that the present FOMC owes as much to historical context as to economic theory. The Committee should have no reluctance to strike a different compromise today in the light of different circumstances.

It was not until the Federal Reserve Act of 1913 that central banking became a subject of federal regulation at all. President Woodrow Wilson and the Progressives created a centralized banking agency in order to make the nation's monetary and fiscal policies more accountable and more stable. However, the Federal Reserve Act failed to centralize open market operations. Instead it authorized the regional Reserve Banks to

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trade commercial paper in the open market under rules which the Federal Reserve Board could set, but not enforce. Because each bank could disregard the federal policy, the plan soon failed.

In 1922, open market trading was placed under the control of an Open Market Investment Committee, a body of regional Reserve Bank presidents who again were given the authority to recommend policy but not enforce it. The Federal Reserve was first given a statutory role in open market trading in 1933 with the creation of the Open Market Policy Conference. The Conference was comprised of representatives from of each Reserve District. It recommended open market policy to the Board of Governors, which could accept or reject its advice.

The Federal Reserve Amendments of 1935 for the first time gave the Federal Reserve the authority to initiate open market operations. Representative Henry Steagall of Alabama, on behalf of the Roosevelt Administration, proposed that the Federal Reserve alone conduct open market operations, with advice from the regional Reserve Bank presidents serving as an advisory committee. The Administration's proposal is similar to the bill before this Committee today.

Senator Carter Glass of Virginia, then Chairman of this Committee, resisted giving greater influence over open market trading to the government, and instead insisted that private bankers, in the form of the regional Reserve Banks, keep their role. The Conference Committee compromised on the arrangement which exists today: open market operations are conducted by a

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Federal Open Market Committee of twelve members. Seven of those members are the Board of Governors of the Federal Reserve, and five are private bankers selected by the regional Reserve Banks from among their presidents and first vice presidents. The FOMC has full power over open market trading, and their decisions are binding on the Reserve Banks.

The FOMC as it is now organized affronts both the nondelegation doctrine and the separation of powers. The nondelegation doctrine states that Congress may not delegate its lawmaking responsibilities without setting precise standards to guide its delegates' discretion. The constitutional balance between the executive and legislative branches requires that the president have the power to appoint, and in most cases to remove, officers in charge of executing the laws. These controls--the setting of standards, and the power of appointment or removal--ensure some measure of public accountability in the making and execution of public policy. None guide the actions of the Reserve Bank representatives of the FOMC.

Federal law currently directs the FOMC to govern "with a view to accommodating commerce and business." 12 U.S.C. § 263(c). Given the fluid and imprecise nature of open market trading, it is probably impossible for Congress to set more precise guidelines. But if the delegate's discretion cannot be constrained, it is all the more important that public officers have a voice in the delegate's selection or removal.

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No such voice influences the Reserve Bank representatives, who are selected by the boards of directors of the regional Reserve Banks without congressional approval. The members of the Board of Governors, by contrast, are nominated by the president and confirmed by the Senate, in accordance with Article II of the Constitution. The Supreme Court has held in Buckley v. Valeo, 424 U.S. 1 (1976), that officers of the United States must be appointed in accordance with Article II. Given that the Reserve Bank representatives exercise the same authority on the FOMC as the members of the Board of Governors, there can be no reason why they should not also be nominated and confirmed.

Finally, the Reserve Bank representatives cannot be removed by the president. The members of the Board of Governors can be removed for cause, but it is a matter of some debate whether the Reserve Bank representatives are subject to even this much control. Thus five private bankers are given authority to help set the nation's money supply without legislative standards to channel their discretion, a chance to review their credentials before appointment, or a means of controlling them afterwards.

The most obvious objection to such an arrangement is that it shelters Congress from accountability for its actions. Open market trading is not intrinsically a function of government. For a good portion of the country's history we have been content to leave it in private hands. But having decided to make open market trading a governmental function, it is important that

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those who exercise this power be in some way accountable to the public.

Reserve Bank officers no doubt have unique expertise and bring a useful familiarity with regional banking conditions which might otherwise be missed. Theirs is not the only interest or the only expertise which might be brought to the FOMC. But theirs is the only private interest so represented.

Nor can their role be explained on the ground that open market trading is a technical act best conducted by experts. Open market trading is intrinsically a political act. There is no objective, scientific way to conduct monetary policy without reference to the particular goals desired. The FOMC determines in large part whether the country should pursue a policy of rapid or cautious growth. The sensitivity of these decisions may be a reason to insulate these decisions from partisan influence, but they do not justify removing them entirely from the political process.

Such delegation also deprives the president of his responsibility to see that the laws are faithfully executed. Restrictions on the president's power to appoint and remove federal officers weakens the authority of the executive branch, usually to the benefit of the legislative branch. When power is delegated to private citizens, as in the case of the FOMC, no one retains accountability and any means of ensuring that public policies are followed is lost.

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The Monetary Policy Act Reform Act would redress these problems by again making public servants--the Federal Reserve Board of Governors--responsible for open market trading. They would remain shielded, as they are now, from overt political pressure, although they would be also remain subject to review upon their appointment.

Private interests would also to be served under this bill, but in a different way. The Reserve Bank officers would have a formal advisory role. They would meet four times a year with the Board of Governors to present their complaints and to share their regional and professional insights. They would have, as any group of citizens has, the ability to petition the government for the redress of their grievances. But they would no longer have a formal vote, beyond that allowed any other affected interest, to actually determine what public policy will be.

Delegation of governmental power to private citizens occurs with increasing frequency and perhaps a concomitant lack of comment. The Supreme Court has allowed a great deal of delegation, so long as it does not impinge too much on the president's ability to see the laws faithfully executed. The Court has not addressed the structure of the FOMC. As Senator Riegle knows, there are great procedural barriers to bringing such as suit. Two other members of Congress--former Senator Melcher of Montana and former Representative Reuss of Wisconsin--have tried unsuccessfully. Several previous attempts to reform the FOMC by legislation have also failed.

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The structure of the Federal Open Market Committee is a suitable topic for a law review note--esoteric and seemingly impervious to any actual resolution. But the structure of the FOMC deserves reform because it gives private interests the responsibility for implementing policy Congress has determined should be in public hands. It vests in private citizens a vote on a select council determining the economic direction of the country. Congress has determined that these policies are important enough that the government should decide them, but it gives to private interests what is often a decisive vote.

The recent reports of disagreement between the public and private members of the FOMC demonstrates the flaws of the system as it is now arranged. The particular monetary policies each group hopes to pursue are beside the matter. What does matter is that the portion of the FOMC which is accountable to the public is at odds with the portion which is not. Private interests can be accommodated within a public board by giving to private bank representatives a voice in setting policy, but leaving the decision to public officials.

I hope the Committee will favorably report S. 1611, the Monetary Policy Reform Act of 1991, which I believe successfully addresses the constitutional flaws of the FOMC.

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Senator SARBANES. Well, thank you very much.

Of course, Professor Tobin suggests a different approach, I take it it's his preference, which would be to somehow make these presidents publicly accountable.

Mr. BERNSTEIN. That's actually the approach that I advocated in my note. I think this is another way of doing it which is equally acceptable.

Senator SARBANES. I'm not sure what the reaction of that would be. Of course, those that are in don't want to change the system in any way whatever. Maybe you should say to them, well, it's going to be changed. Which of the ways do you think is the better way to change it, and see how they address that question.

Mr. Seiders, I wanted to make one point. I think it's true that, to some extent, this issue has been touched off recently because of the perception that the Board of Governors wanted to move a little more responsibly to the recession and were being checked by the presidents.

The dissents don't really reflect the amount of the check. You get a Board decision. You have certain people dissenting. Then some people say, well, they dissented, but, by definition, as a dissenter, they were in the minority. The Board went ahead and made the decision anyhow. So what was lost?

It doesn't really work that way. A lot of the Board's decisions are made unanimously or by consensus, and these people are exercising an influence in that process.

So at the previous meeting, they may well have not dissented because the Board, in effect, adjusted to the position they took, for example.

But I do think that there's a bigger issue, so to speak, a broader issue, a more basic philosophical issue. And that is that even if these presidents were on the other side, it's still legitimate to raise the point that they're not accountable to anyone. And there's no way to sort of draw them into a network of accountability.

Of course, Mr. Hilty's testimony really suggests an even narrower sense of unaccountability than we've been talking about. We're talking about a kind of a sense of accountability to a kind of a broad public interest.

We don't have a consumer person on the panel here, but I'm sure if we brought them in, they'd say, well, we get very short shrift out of these people.

But now we're being told that there's a major sector of the economy that feels that he was getting short shrift and I think that's probably sustained.

I take it that the homebuilders—to what extent do you think that the monetary policy is directly responsible for the very poor housing starts that you've been reflecting over the recent periods?

Mr. Seiders. Let me say, first of all, that the housing market, if you look back over a very long period of time, has always been quite cyclical. So we expect ups and downs. We've had some very strong years through the mid-1980s and expected a slowdown. And there are some special factors in this cycle that have been a real problem.

As I mentioned, swings in the tax code, 1981 tax act, 1986 tax act, created conditions for a major fall-off in the multifamily piece

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of the market. And the regulatory credit crunch we've been dealing with now for almost 2 years also has been a real problem. So we expect to go up and down. We have special factors almost all the time.

As I mentioned, our assessment of the Fed's management of monetary policy over the last couple of years is really not overwhelmingly negative. There were a couple of occasions, throughout a good bit of 1990, frankly, where both the discount rate and the Fed funds rate were held dead steady for a good while, when, as we now know, the economy was still weakening. And then around the middle of this year, we went into another holding pattern. I think it was not a good idea.

So I think that there have been some policy mistakes that have hurt the housing industry more than was necessary. I would view them as mistakes, I think, at this point.

Senator SARBANES. What's your explanation for the fact that while interest rates are now, in a sense, down—we don't seem to be getting the correlation between a downward movement in the interest rates and an upward movement in the housing market.

Mr. SEIDERS. That's right.

Senator SARBANES. The same thing is true of autos, as a matter of fact.

Now, what's your explanation?

Mr. SEIDERS. Toward the end of last year, with the Persian Gulf crisis thrown in and everything else, the economy and the housing market really did start to roll downhill. We got a little bit of euphoria after the war was cleaned up. But just the overall weakness of the economy, the condition of the financial sector, people now worried about life insurance companies as well as other things, weak job growth and income growth have really decimated the condition of consumer confidence. It's now down to 1982 levels.

Senator SARBANES. It dropped 12 points last month.

Mr. SEIDERS. That's right, to abysmally low levels. And most people don't need to go ahead with house purchases, and certainly, auto purchases are also highly postponable.

In our own forecast, we are really counting on the lower interest rates, now being aided and abetted by the Fed fairly aggressively, to help bring enough buyers across the line, with decent job prospects and so forth, to get the economy stabilized and moving upward in 1992. But it's going to be, I think, quite a close call.

Senator SARBANES. What's your view on that, Mr. Hilty? Why, when you get some easing of credit out there, are we not getting a response on the purchasing in your instance, I guess, automobiles, but it's the same thing that I think is true of other major durable goods as well.

Mr. HILTY. That's correct. We feel that because monetary policy didn't loosen quick enough, we went into a deeper recession than we would have had to.

Since we went into a deeper recession, and other industries did the same thing, cutting costs seemed to be the way to try to survive this lower-than-normal recession.

Senator SARBANES. What's the way? I'm sorry?

Mr. HILTY. Cutting costs.

Senator SARBANES. Cut costs, OK.

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Mr. HILTY. Lay off people, mainly. This has snowballed. The lack of employment opportunities I think is the main culprit now that's keeping consumer attitudes so low.

I wanted to also comment about——

Senator SARBANES. Actually, the Labor Department brought in a report 2 weeks ago that the real income of wage and salary earners, which is essentially our middle income people, the real income declined over the year. From the third quarter of last year to the third quarter of this year, money income went up 1.8 percent, prices went up 3.9 percent.

So people actually in real terms were worse off at the end of the year than at the beginning of the year.

Mr. HILTY. That's correct. That's still the case. We look at real income for households and it's still running lower than a year ago.

And more the Labor Department has announced that they'd been overestimating payroll numbers. That's one bit of hope we were all clinging to, that the payroll numbers seemed to be increasing.

This led some of us to believe that maybe a recovery was underway. But that prop has been taken out from under us now, too.

I wanted to comment about the spectre of long-term interest rates rising. It seems we're being held hostage to prospect.

Don't stimulate the economy because long-term rates might go up. Don't change the composition of the open market committee because long rates might go up. That seems to be the whipping boy or the spectre that's got us in paralysis in this country just now.

Mr. SEIDERS. It's a factor definitely to be dealt with, though. It's the way the market is now functioning.

Senator SARBANES. What did you think about Professor Tobin's reaction to that? He says, look, if they get out of the long-term securities——

Mr. HILTY. Where do they go?

Senator SARBANES.—where are they going to put their money? Ordinarily, they put them into short-term securities. It's been happening in the short-term securities since the cutting of the rates. They're getting them out of the long-term securities, so they end up with a sort of Hobson's Choice.

Mr. SEIDERS. Well, the stock market is another option, certainly.

It happens. I mean, we see it happening in the market. You mentioned, yourself, a producer price number comes out this morning that's beyond expectation. You get an immediate bond market reaction. Interest rates go up in the midst of what we think is an ongoing recession.

Senator SARBANES. All the alarm bells will be ringing.

Mr. SEIDERS. It's not the way that I would prefer that the markets operate. But I think that, with the experience of the late 1970's and early 1980's, that has not been forgotten.

The problem with bonds is that you get a certain change in interest rates and it will affect the value of a long-term instrument by a great deal. So it's really the capital losses on bond holdings that are the concern. That's why you get bonds moving in large quantity onto the markets when these concerns arise.

Senator SARBANES. Well, gentlemen, we thank you very much. You've been a very helpful panel and we particularly appreciate

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the obvious care that went into the preparation of the statements that you submitted.

Thank you very much.

The hearing is adjourned.

[Whereupon, at 1:05 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

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CASE WESTERN RESERVE UNIVERSITY

November 12, 1991

The Honorable Lee H. Hamilton
Vice-Chairman, Joint Economic Committee
Room G-01, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Representative Hamilton:

I am writing in support of H.R. 3176 & S. 1611, which propose altering the composition of the Federal Open Market Committee to exclude presidents of the Federal Reserve banks, who are neither appointed by the President nor confirmed by the Senate. As currently constituted, the participation of private members on the FOMC raises fundamental constitutional concerns because the private individuals are not accountable to the public for their exercise of governmental authority. The proposed bills would rectify that constitutional flaw by limiting the role of the private bank presidents to advice, a function fully compatible with the private status of the bank presidents.

Delegations outside the federal government threaten the integrity of our system of separated powers. Under our system, governmental policy can generally be fashioned in one of two ways. First, Congress can itself set broad or specific policy through legislation. Congress is of course accountable to the electorate for its policy decisions, and its legislative efforts are checked by the Article I constitutional requirements of bicameralism and presentment. Two houses of Congress must agree before any bill can become law, and that agreement must then be presented to the President for his approval. A presidential veto is subject to an override by 2/3 of each house.

Alternatively, Congress may choose under Article I to delegate some of its authority to officials within the executive branch. Whether for reasons of expertise, efficiency, or political expediency, Congress has perhaps too often determined that a member of the executive branch is best positioned to carry out a legislative program. The executive official's exercise of delegated authority is not checked -- as is Congress' formulation of policy -- by bicameralism and presentment. Nonetheless, significant checks exist. Congress must agree as an initial matter to delegate the authority to the executive, Congress can always rescind the authority, the judiciary may review the delegate's exercise of authority for conformance to the terms of the original delegation, and the President under Article II superintends that exercise of authority. The President maintains control or

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supervision through the power to appoint and remove officers of the United States, through executive orders, and through party discipline. The President thus stands accountable to the public for the exercise of authority delegated to subordinate officials within the executive branch.

Delegations to private parties outside the government, however, are constrained neither by the leavening requirements of bicameralism and presentment, nor by the crucible of public opinion. Such delegates are not as accountable for their formulation of policy as are members of Congress or the executive branch. There are fewer political checks circumscribing their actions, and the result may be unreflective or arbitrary governance. Even if the private individuals exercise their authority with the utmost good faith, they set policy that the rest of us must follow without facing the possibility of adverse public reaction. The continuing exercise of authority by private individuals as crafters of national monetary policy establishes an alarming precedent for future abdication of authority to private parties.

Consider Congress' initial decision under the Gramm-Rudman-Hollings Act, 2 U.S.C. §§ 901-07, to vest in the Comptroller General the power to perform budget cutting duties. The Supreme Court invalidated the role ascribed to the Comptroller General in the budget reform measure because it would have afforded that officer, whom the Court deemed an agent of Congress, the power to participate in the execution of the laws -- in this case, implementing Congress' budgetary guidelines. Relying on the FOMC structure, Congress might have responded by vesting identical responsibilities in a private individual such as the head of the Brookings Institution. Although perhaps less controversial, the head of the Brookings Institution would have been far less accountable to the public for the subsequent exercise of budget cutting duties than the Comptroller General, who is appointed by the President, who must abide by a welter of regulations (such as conflict-of-interest rules) applicable to most government officers, and who is subject to removal at the initiative of Congress.

Moreover, delegations outside the federal government may impermissibly alter our constitutional structure of government in a number of ways. As an initial matter, such delegations jeopardize unified implementation of the law, because the President cannot coordinate that exercise of authority with his other responsibilities. The result may be decentralized, fragmented stewardship.

Furthermore, through delegations to private parties, Congress may be able to wield excessive power. Because the private individual is outside the government, only Congress can call the private delegate to account for his or her exercise of responsibility by threatening to withdraw the delegation. While Congress'

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power to withdraw the delegation may permit some accountability, that power, in the absence of any other supervising authority, may create a "here-and-now subservience" which would effectively transform the private individual into an agent of Congress. Agents of Congress may not participate in the execution of laws which bind those outside of Congress. Otherwise, Congress could circumvent the constitutional restrictions on its mode of action -- bicameralism and presentment -- and indirectly usurp executive branch control over delegated authority. See Bowsher v. Synar, 478 U.S. 714 (1986); INS v. Chadha, 462 U.S. 919 (1983).

Despite the grave constitutional difficulties, I recognize that Congress has long delegated some authority outside the federal government. For instance, it has delegated considerable authority to state governments in implementing social programs such as Medicaid (Title XIX of the Social Security Act, Pub. L. No 89-97), and in implementing strategies to abate air pollution under the Clean Air Act (Pub. L. No. 91-604, 84 Stat. 1676). Congress has also delegated authority to Indian Tribes to help manage their own territories. See, e.g., Rice v. Rehner, 463 U.S. 713 (1983) (upholding delegation to Indian Tribes of right to regulate liquor purchases within territories). In addition, Congress has delegated power to private groups, such as tobacco growers, who are the targets of governmental regulation, see, e.g., Currin v. Wallace, 306 U.S. 1 (1939) (upholding delegation to tobacco growers of the power to veto the Secretary's designation of an auction market), and to private attorneys general who can initiate civil suits (qui tam actions) on behalf of the government. See, e.g., United States ex rel. Marcus v. Hess, 317 U.S. 537 (1943).

With the exception of the FOMC, however, the delegations outside the federal government which I have studied have been circumscribed in at least one of three critical respects. First, most of the delegations have left the executive branch with significant control over the exercise of delegated authority. States exercise some discretion in implementing the Clean Air Act, for instance, but their plans must meet EPA standards. See, e.g. Train v. Natural Resources Defense Council, Inc., 421 U.S. 60 (1975). Similarly, tobacco growers and other producers of agricultural products enjoy a limited veto over proposed governmental regulation of their products, but the Secretary retains ultimate authority over all major industry practices. See generally Block v. Community Nutrition Institute, 467 U.S. 340 (1984); see also Currin v. Wallace, supra (Secretary retains effective control over regulation of tobacco growers). The limited authority delegated to such producer groups does not significantly interfere with the Secretary of Agriculture's control over marketing practices. In addition, the executive branch currently exercises substantial control over qui tam actions. See, e.g. 31 U.S.C. § 3730(c) (providing that government must have notice and may intervene in suits filed by private relators under False Claims Act).

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Second, irrespective of the executive branch's continuing control over most of the authority delegated outside the executive branch, the delegate's exercise of authority may be subject to an alternative political check. Accountability may exist, in other words, apart from the supervision exercised by the President. Most notably, Congress' delegations to states and Indian Tribes follow that paradigm. State officials implementing the Medicaid program or the Clean Air Act may be accountable not only to the executive branch but to the state electorate for their actions. Such officials are responsible to their own constituencies.

Third, almost all of the authority delegated outside the federal government is quite narrow, permitting those subject to federal regulation to take part in facilitating industry standards and practices. Delegations to producer groups permit such groups to help shape marketing practices and research priorities which affect their livelihood. Congress in the past analogously delegated the power to the American Railway Association to establish a mandatory drawbar height on railway cars. Saint Louis, Iron Mountain & Southern Ry., 210 U.S. 281 (1908) (upholding the delegation). Only those subject to the governmental regulation typically participate in defining the details of that regulation.

Delegation of authority to the FOMC thus stands on a different footing from all other delegations outside the federal government. First, private members of the FOMC are not constrained by executive branch supervision because their votes can be dispositive on particularly divisive issues. Although seven of twelve members of the FOMC are appointed by the President and subject to confirmation by the Senate, the five private members of the FOMC can readily influence or even determine monetary policy when the presidential appointees are split. Moreover, in setting monetary policy, the private members need not follow any guidelines set by the executive branch.

Second, the private members -- unlike state officials or officials of Indian Tribes -- are not politically accountable for their conduct of public business. As bank presidents, they are responsible to their boards of directors and not to the public at large. President Franklin Roosevelt reportedly rejected a proposal that banks should be delegated the authority to monitor themselves during the Depression: "Imagine what national policy would be like if, instead of requiring such group to conform to the public interest, they were free to bargain about what they would or would not consent to accept. Outrageous." W. Leuchtenburg, FDR and the New Deal 90 (1963).

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Finally, the delegation of authority to the private members of the FOMC is unquestionably broader than other delegations we have witnessed. The FOMC sets national monetary policy of indisputable import; unlike producer groups and state governments, its power is not confined to the concerns of one geographical entity or one industry. The authority of the private members on the FOMC stem from their presumed expertise in national affairs -- their banks are no more affected by national monetary policy than are countless industries across the nation.

In short, my study of congressional delegations has convinced me of the far-reaching dangers of entrusting public power to unaccountable individuals. The participation of private members on the FOMC cannot be easily reconciled with the focus on accountability underlying our system of separated powers. I therefore enthusiastically support H.R. 3176 & S. 1611, which would remove the constitutional doubts afflicting the agency, and which might in so doing enhance the agency's ability to act in the public interest.

Very truly yours,

Harold J. Krent
Visiting Professor of Law

HJK:bk

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